MERGERS AND ACQUISITIONS: COMPARATIVE STUDY ON MANAGEMENT BUY-OUTS IN UK AND CHINA

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Summary

Management buy-outs("MBOs") can be defined as transactions involving the purchase of a business by its management, usually in co-operation with outside financiers. It originated in UK in the late1970s and spread rapidly in the early 1980s.

MBOs are an increasingly integral element of global corporate finance, however, their nature and extent varies considerably from country to country, depending upon the particular characteristics of individual business, industrial base, financial and entrepreneurial backgrounds. In addition, the present state of MBOs in any country depends upon the stage reached in the life-circle of this form of ownership change.

The popularity of MBOs is a relatively recent phenomenon in China. The market and legal regime for MBOs in China lags considerably behind development in UK. But MBO is beginning to become an important innovation in China's economic reform.

In many recent mergers and acquisitions deals in China, MBOs have occurred and risen in popularity over the past several years. Since the 15th National Congress of the Communist Party of China held in September 1997, many state-owned companies and collectively-owned enterprises in China utilize MBOs to privatize and clarify the ownership, convert themselves into standard companies and stimulate the management. Some legislation was issued to facilitate the growth of MBOs. The adoption of the landmark statute, the Measures for Administration of the Acquisition of Listed Companies in December 2002 marked the beginning of Chinese legislation in the management buy-outs sector.

MBOs are an important innovation in China's economic reform. However, in spite of the issuance of several supportive rules and regulations pertaining to MBOs over the past years, there remain quite a lot of obstacles and risks when conducting the deals under the Chinese legal regime. Moreover, China has an undeveloped capital market, the industrial banks have had problems with both debt finance and equity investments, and the venture capital market in China, unlike UK is at an early stage of development. Thus, there has been a growing debate that management buy-outs are now at the crossroads.

The MBO deals will be motivated by China's further reform of state-owned enterprises, and the changing of government's economic function after China's entry to the WTO. To take advantage of MBOs during the special period of state-owned enterprises' reform, relative laws and regulations should be improved or established. For example, the merits of current laws including the Chinese Company Law could be maintained, but defects and unreasonable prohibitions in them shall be eliminated. Also, other supplemental regulations and sophisticated modern English law in regard to MBOs shall be also taken in such laws. Furthermore, a unified code on MBOs is essential to avoid legal loopholes and discrepancies existing in the present China's law. Finally, to prevent loss of state-owned assets, and protect the shareholders of the Target Company, government supervision and a unified state-owned property law is necessary.

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Chapter 1: Introduction of the study

Recent trends in China's economy indicate that mergers and acquisitions activities are growing more and more important compared with traditional business incorporating activities. In many recent mergers and acquisitions deals, an especially common type of leveraged buyout, management buyouts("MBOs"), have occurred and risen in popularity over the past several years. In particular, many state-owned companies and collectively-owned enterprises in China attempt MBOs to convert themselves into standard companies in terms of a clarification of the ownership and the investors' rights and responsibilities in such companies or privatize the ownership and stimulate the management.

Management buy-outs first came to prominence in the U.K. during the late 1970s, and developed greatly in US and Europe thereafter. Management buy-outs are no longer a rare occurrence; they are now one of the most popular forms of acquisition in UK economy. During 1979, 18 MBOs took place in the U.K., with a total value of £14m. Today, in an average month, up to 50 MBOs will be completed and around £2 billion will change hands in the process. In 2003, there were over 680 MBO transactions recorded with a market value of £16.1bn.[1] In recent years management buy-outs have become a common feature in UK's corporate market.

As noted above, MBOs are an increasingly integral element of global corporate finance.

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[1] A Practical Guide to MBOs, online: Deloitte <http://www.deloitte.com/dtt/cda/doc/content/Guide%20to%20mbos.pdf>.

Nonetheless, the popularity of the transaction is a relatively recent phenomenon in China. Since the 15th National Congress of the Communist Party of China held in September 1997, the state owned enterprises (listed and unlisted) have experienced a substantial change including ownership. The problem of a lack of motivation for managers of the enterprises to work more effectively has become one of critical issues facing state-owned enterprises development. Notably, MBOs are one of the instruments that can be used to push state owned enterprises to convert themselves into standard companies and explore incentives for enterprise managers. Meanwhile, privately owned enterprises would also like to take advantage of MBOs to facilitate their divestment of non-core divisions and subsidiaries and reorganization of diverse shareholders.

In recent years, a variety of laws and regulations related to mergers and acquisitions in China were promulgated and revised. In spite of issue of several supportive rules and regulations pertaining to MBOs over the past year, there remain quite a lot of obstacles and risks under the Chinese legal regime. Some practices were conducted in the absence of successful experience and supportive regulations.

While transactions of MBOs develop rapidly in China, an official suggestion which got in the way of development of MBO transactions was adopted by the Ministry of Finance(“MOF”) of the PRC in March 2003, pursuant to which, approval shall not be granted by relevant government departments to any transaction of MBOs, including MBOs of listed and unlisted companies, prior to the promulgation of the relevant law governing MBO transactions. Later in December 2003, the State-owned Assets Supervision and Administration Commission of the State Council issued an official opinion which places a strict prohibition on acquiring the ownership of a state-owned company by its management and through financial assistance. Accordingly management involved in a state-owned company is precluded from the process of MBO transactions including decision-making, audit, and property evaluation. And management is prevented from using the company's own funds to finance purchases. Thus, there has been a growing debate that management buy-outs are now at the crossroads.

This research is intended to study the brief commercial background, practical structure and principal legal issues that arise in the management buy-out activities in UK and those in China. This article is divided into seven chapters. It starts with an overview of the nature of the management buy-outs and the general comparisons between MBOs in UK and China. It is followed by a discussion of the legal issues concerning MBOs in UK. The emphasis will then be placed on the latest MBOs deals in China. The paper continues with a detailed analysis of problems arising from the current MBOs in China and defects in the current Chinese laws and it ends with a proposal for the improvement of the Chinese legal regime concerning MBOs.

I proceed on the assumption that the reader has a basic grounding in the issues which arise in UK and China corporate mergers and acquisitions transactions generally. It is hoped that this thesis may in itself stimulate interest in the MBO process and result in an increased flow in transaction volumes to the benefit of shareholders, management team members, investors and the like. It is also hoped that this research will be a useful read for other professionals involved, such as the legislator, lawyer, as well as accountants.

This research does not deal in any detail with taxation issues. Taxation issues are only referred to where to do so is helpful to explain how the management buy-out transaction is structured.

Chapter 2: Introduction and analysis of the management buy-outs

Before comparing UK and China management buy-out in this article, some basic contents of MBOs should be clarified. First is the definition of MBOs, although no clear definition for MBOs is provided by relevant Chinese laws or regulations.

I. Definition of MBOs

Management buy-outs can be defined as transactions involving the purchase of a business by its management, usually in co-operation with outside financiers. Buy-outs vary in size, scope and complexity but the key feature is that the managers acquire an equity interest in their business, sometimes a controlling stake, for a relatively modest personal investment.[2]

An MBO is commonly achieved through the following steps.[3] First, a new company("Newco") is established to acquire shares or business in a target company ("Target"). Next, Newco and Management agree terms with equity investors and with bankers to fund the acquisition of Target and to provide working capital. If there is a funding "gap" between the equity and debt funds available and the funds required, this may be filled by mezzanine funding, which ranks

[2] Glossary- MBO, online: The Center for Management Buy-out research <http://www.cmbor.org/>.
[3] Niall McAlister, "Management Buy-outs: Issues Affecting Management and the Seller", International Company and Commercial Law Review, ICCLR 1998, 9(9), 248-254.

behind “senior” bank debt but in priority to equity (and may include a right to subscribe for equity). Then management and the equity investor subscribe for shares in Newco and Newco’s bankers (and, if relevant, the mezzanine funders) commit to provide debt facilities. Once funds are in place, Newco completes the acquisition of Target.

Thus, a word of explanation on the use of the terms “Newco” and “Target” may be helpful. The managers of a business become its owners or major shareholders. However, the managers have insufficient funds to buy the company outright and therefore need a third party to finance the deal. Newco is the term used to describe the limited company which management and outside financiers will set up and in which they will subscribe for shares. It is Newco which will purchase either the shares in the company or the business and assets of the company being sold by the vendor. Management will hold a majority or a substantial minority of the equity in the new company. Target is the term used to describe the company being sold by the vendor to Newco although, it should also be read as referring to business and assets being sold.

A buyout can provide a management team a once in a lifetime opportunity both to prove themselves and to generate unachievable leverage of their personal wealth if the target company operates well. Nevertheless, the buyout is not only focused on the generation of capital gains for the management team and their financiers, it also demonstrates a significant and long-lasting influence on corporate ownership structures. In the domain of corporate finance, the buyout has grown to play a major role in the Mergers and Acquisitions market and one of the most important tools, compared with the situation when it was only an obscure offshoot of the fledgling venture capital industry in the mid-1980s at its starting point.[4]

II. The spread of the management buy-outs concept.

The concept of MBOs originated in the United State in the 1950s, but it was only in the late 1970s that the phenomenon began to occur with any frequency in the U.K..[5] In 1980, Mike Wright, at the time working on divestments, noticed that a number of companies were being divested by means of a sale to the management. At that time, he had identified the phenomenon but did not know what to call it, thus, an interest in the phenomenon with no name was born. Following the discovery, it was in the early discussion that the title "management buy-outs" was introduced at the Industrial and Commercial Finance Corporation ("ICFC"). The idea for further and more detailed research was formed following the first national conference on management buy-outs which was held at Nottingham University in March 1981, and jointly organized by the University and ICFC. This conference attracted a great deal of professional and industrial delegates, and demonstrated that the buy-out was both a significant development on the UK commercial scene, and an activity worthy of further research,[6] and thereafter, gave rise to the spread of the MBO concept and the growth of MBO transactions in the U.K. and continental Europe.

III. An agency theory perspective on MBOs.

An agency theory perspective was adopted in UK on MBOs, which has direct implications for

[4] Gary Sharp, Alex Shinder, ed., *Buyouts: A Guide for the Management Team* (London: Euromoney Books and Montagu Private Equity, 2003) at 1.
[5] Weinberg & Blank, *Takeovers and Mergers*, looseleaf (London: Sweet & Maxwell, 2003) at 2-6003.
[6] Mike Wright & John Coyne, *Management Buy-outs* (London: Croom Helm, 1985) at preface.

how buyouts affect productivity. That is because buyouts typically result in a change in the incentive and governance structure of the corporation.[7] In publicly-traded corporations, peak tier agency problems may arise where management hold negligible amounts of equity and diffuse shareholders are unable to exert effective monitoring. A second tier agency problem arises in divisions of large public corporations. Incomplete labor contracts in internal capital markets raise the possibility of opportunism and a resultant need for monitoring. This monitoring may be ineffective when remuneration of senior management is not linked to performance and access to divisional information may be problematical in large complex organizations. Difficulties in introducing appropriate performance-related incentives at the level of individual divisions may compound these problems.[8]

Following an MBO, senior management typically obtains a significant share of the equity, with a small group of private equity investors retaining the balance. The subscribers of this private equity, whether a leveraged buyout association or a private equity firm, provide close monitoring of the target company through requirements for detailed information, board representation, etc.. Taking on significant debt to fund the purchase of the company introduces a major commitment to service this financing because of the threat of bankruptcy should interest payments not be met. Debt providers also set and monitor a range of covenants as a condition of extending loan finance.[9] These changes in incentive and governance

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[7] Richard Harris, Donald S. Siegel and Mike Wright, "Assessing the Impact of Management Buy-outs on Economic Efficiency: Plant-Level Evidence from the Unite Kingdom." (October 2003), Working Papers in Economics, Rensselaer Polytechnic Institute, online: <http://www.rpi.edu/dept/economics/www/workingpapers/>.
[8] Thomson, Steve and Mike Wright, "Corporate Governance: The Role of Restructuring Transactions," (1995) Economic Journal, Vol. 105, 690-703.
[9] Citron, Ken Robbie and Mike Wright, "Loan Covenants and Relationship Banking in MBOs," (1997), Accounting and Business Research, 27, 277-296.

mechanisms are expected to lead managers to seek out more efficient uses of factors of production.

IV. General reasons for MBOs

Why are management buy-outs of corporations, subsidiaries and divisions common today? There have always been many corporate transactions as companies have been bought and sold and have divested operating units for strategic reasons. MBOs are now a world-wide phenomenon. There are many reasons for the large number of these transactions.

First, large corporations are focusing their resources on their main lines of business and divesting other operations to stay viable in the highly competitive world economy.

Second, management is widely believed to work more efficiently when it owns a piece of the action and some of its capital is at risk in the business. There is more incentive for each manager to prove themselves and there is less need for the costly supervisory and monitoring systems that typify large, absentee-owned corporations and conglomerates.

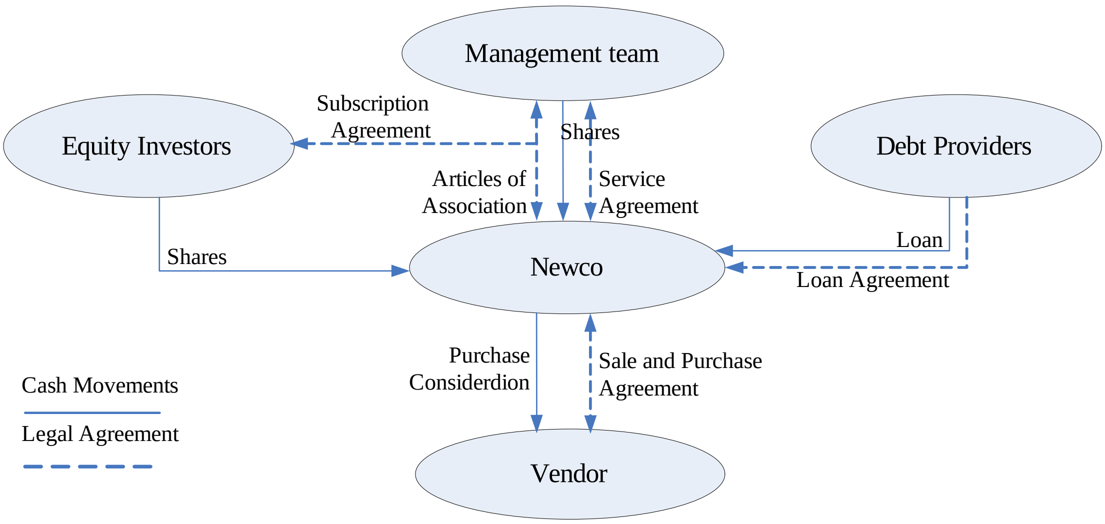
Third, management not only works harder when they are owners, but they expect the entire organization to work harder and smarter to enhance the value of their ownership. Managers are in a better position then absentee owners to demand and develop better performance from the organization.

Fourth, as investors have become more sophisticated, they would rather make their own decisions concerning diversification (by investing in companies with different lines of businesses) instead of investing in a single corporation whose management makes such decisions by diversifying the company's assets through conglomeration.[10]

V. Legal relationship and structure of MBOs

Some management buy-outs are straightforward affairs with the owners of the business selling to a manager or a group of managers personally. However, where the sums involved are large and the management team needs to raise finance from external sources, the process becomes more complicated.

Figure 1: The Legal Relationships of the Parties in MBOs



It is not unusual for a buy-out to involve four or five different parties including the vendor, which may be a company, private or public, an individual, a number of individuals, a receiver or the government,[11] the buy-out vehicle, Newco, normally a newly formed company for the

[10] Mike Wright & John Coyne, *supra* note 6 at13.

[11] Debbie Anthony et al., Ian Krieger, ed., *Management Buy-outs*, second ed. (London, Dublin and Edinburgh: Butterworths & Co Ltd, 1994) at 19.

purpose, the funding institutions composed of equity investors or debt providers or both, and the individual members of the buy-out team. The relationships of the parties are illustrated in Figure 1.[12]

Chapter 3. General Comparison of MBOs in UK and China

Te market for management buy-outs in China lags considerably behind the U.K. It can be demonstrated in the following discussion that the reasons, fairly obviously, relate to the nature of the industrial base, ownership structure, the level of development of the venture capital markets, the extent to which banks are allowed to invest in this kind of organization, the nature of acquisition activity, and the level of development of stock markets.

I. History and Background of MBOs in UK

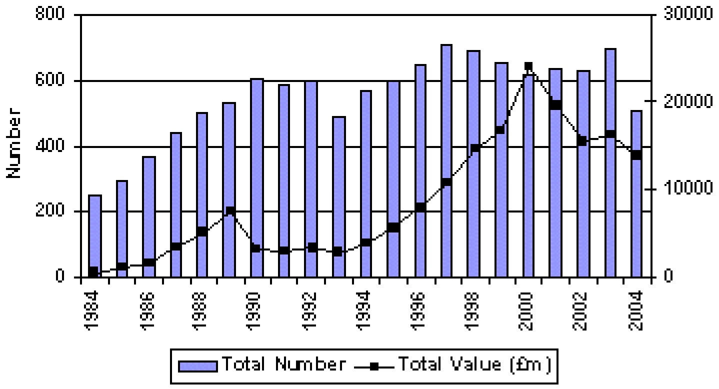
1. Trends of MBOs in UK

The past few years in UK have witnessed an explosion of M&A activity unlike that of any comparable period in recorded history. One aspect of the current M&A trend is the continued use of leverage by financial buyers. The management buyout, an especially common type of leveraged buyout, also has continued to rise in popularity during the 1980s. There was significant growth in the value of assets transferred through buyouts in UK during the 1980s, reaching a peak in 1989. Following a decline in 1990, MBO activity increased virtually monotonically until 2004. Figure 2 demonstrates the rate of this growth in UK, in terms of

12 A Practical Guide to MBOs, *supra* note 1.

both total value and numbers of transactions.[13]

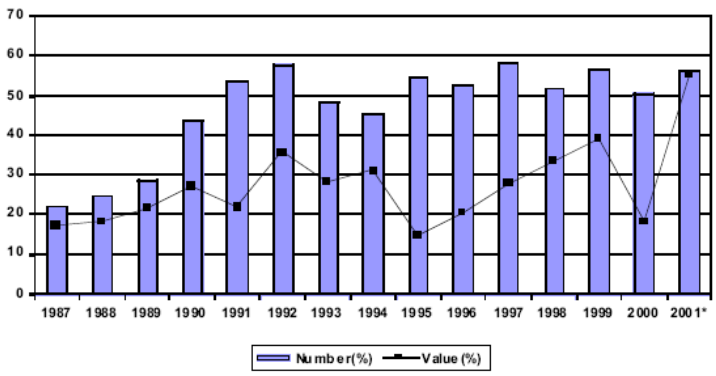
Figure 2: UK MBO Trends (1984-June, 2004)



Source: CMBOR/Barclays Private Equity/Deloitte & Touche

The proportion of mergers and acquisition activity represented by management buy-outs has varied from year to year. As is illustrated by the following Figure 3,[14] they have come to account for approximately half of all such mergers and acquisitions activity in UK in terms of numbers over the period 1987-2001

Figure 3: MBOs as a % of UK Takeover Activity (1987-2001)



Source: CMBOR/Barclays Private Equity/Deloitte & Touche

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[13] Annual Buy-out trends, online: The Center for Management Buy-out research <http://www.cmbor.org/>.
[14] *Ibid.*

2. Historical review

In the U.K. the management buy-out idea started to take off in the late 1970s and spread rapidly in the early 1980s.[15] During the 1980s, the number and the average size of MBOs in the United Kingdom increased substantially, from an estimated 100 MBOs with a value of £40 million in 1980 to a peak of 500 MBOs with a value of £6,490 million in 1989.[16] In the years 1986-89 there were several very large buy-outs exceeding £100 million in size, some of these being financed substantially by debt.[17] However, with the onset of deep recession in the United Kingdom in 1990, the more cyclical businesses which were burdened by high levels of acquisition debt began to run into difficulties. Uncertain stock markets and interest rates rising to 15% gave rise to some spectacular failures to some of the more leveraged MBOs transactions. Inevitably, lending banks subsequently have had to make large provisions to cover their exposure to highly leveraged transactions. As a result, financiers have, since 1990, adopted a much more cautious approach to risk appraisal. A number of equity and debt providers have withdrawn from the market, and those who remain are insisting on more conservative financing structures. This withdrawal of financial capacity has led to a remarkable decline in both the number and the average size of management buy-outs.[18] Nevertheless, it would seem that the management buy-out phenomenon has established a secure position in UK corporate life. Subsequent to 1990, activity has been experienced at a very much lower, but relatively stable level.[19]

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[15] Bryan de Caires, ed., *Management Buy-outs*, (London: Erupmoney Publications Plc, 1988) at 14.
[16] Weinberg & Blank, *supra* note 5 at 2-6003.
[17] Lord Hanson, *Corporate Acquisitions and Mergers - A Practical Guide to the Legal, Financial and Administrative Implications*, 3d ed. (London, Dordrecht, Boston: Graham & Trotman) at 14.01.
[18] Weinberg & Blank, *supra* note 5 at 2-6003, 6004.
[19] Also currently, 2003 saw a reversal in the downward trend seen in the UK buy-out market since the market peaked at £23.9 billion in 2000. With 2001 seeing a fall to £19.5 billion and a further decline in 2002 to £15.3

3. Background behind the growth of MBOs.

Apart from a brief look at historical trends of MBOs in the U.K., it is essential to appreciate the background of this development.

To a substantial degree, the development of management buy-outs in the U.K. is attributable to change in tax and company laws, specifically to the grant of interest relief for individuals on acquisition debt[20] and the permission for private companies to finance the acquisition of their own shares.[21] However, the background of development of MBOs in China is different; this will be explained later in this chapter.

In UK, management buy-outs should also be seen in a sociological context. There are a variety of influences behind the growth of MBOs.[22] First, management buy-outs come from corporate restructuring including large companies or groups disposing non-core subsidiaries, privatizations of stated-owned entities, distress sales, managerial takeovers of family-run firms or private companies and public to private transactions.[23] Another factor is the growth of the entrepreneurial culture. Management buy-outs would not exist without management teams who are willing to take the risks they entail and who are motivated by the rewards they offer. This willingness to pursue this route has been hugely influenced by the concept of

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billion total market value recovered last year to end 2003 at £16.2 billion. The latest figure represents a six per cent increase over the 2002 value and is the fourth highest UK buy-out total ever recorded, although it still remains three per cent below the £16.7 billion of 1999. Buy-out volume also showed renewed strength last year with the highest number of deals completed since 1998 when 688 were recorded. The total last year of 670 buy-outs was an eight per cent increase on the 620 of 2002 and also well above the 2001 figure of 634 transactions.

[20] See Lord Hanson, *supra* note 17 at 14.06-14.09 for further discussion.

[21] See Chapter 4 IV "Financial assistance and MBO under Section 151 of the Companies Act 1985", below, for further discussion.

[22] Garry Sharp, *supra* note 4 at 9

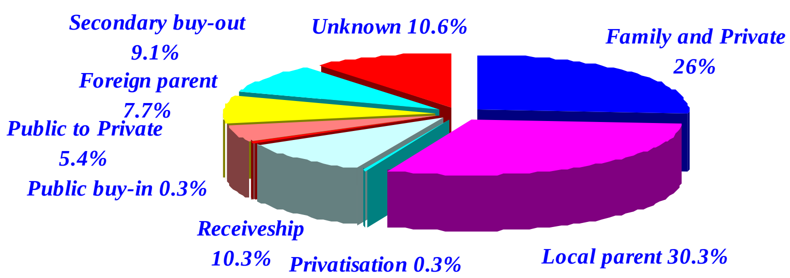
[23] See Source of Management Buy-outs, below.

entrepreneurship independence. This concept contributes much to the modern corporation, as it can be seen that the essential elements of the entrepreneurship, risk taking, risk assessment and profit maximizing are perhaps the most essential feature of modern companies.[24] Also, the growth of management buy-outs is associated with the availability of funds provided by the development capital market and stock market liquidity.

4. Source of Management buy-outs

The popularity of management buy-outs, where a business is bought from its owners by a management team continues. Opportunities for managers to buy all or part of the company which employs them from its owners frequently occur. The sources of buy-outs are many and varied. In the main, the sources in recent years are shown in Figure 4 and details of them are discussed below.[25]

Figure 4: Sources of MBOs 2003: number (%)



The principal source of UK buy-outs lies in the divestment of divisions and subsidiaries by

[24] Mike Wright & John Coyne, *supra* note 6 at 45.
[25] A Practical Guide to MBOs, *supra* note 1.

domestically-owned parent firms.[26] A division or subsidiary of a larger group is or will become a non-core activity. In these circumstances management can become isolated from the parent company's overall strategy and in consequence may not be receiving the full support of the organization. The parent company may wish to dispose of the subsidiary in order to realize funds to concentrate on particular "core activities".[27]

The second major category of deals involves managerial takeovers of family-run firms or private companies in general. These situations occur when owners of family-owned firms and controlling shareholders of private companies decide to end their involvement as a result of the death or retirement of a dominant entrepreneurial figure.[28] Often, in established family companies no obvious successor exists for the owner or managers planning to retire. In such circumstances the incumbent managers may be able to purchase the company from the retiring family members or, frequently, a suitable solution is a management buy-in, which will see the current management being strengthened with new managers from outside. Besides, in privately owned companies with diverse shareholder groups it is possible for the aspirations of different shareholders to diverge over time and this may require a reorganization of the shareholders. Such reorganization can often include a buy-out of certain of the shareholders.

Thirdly, a substantial proportion of UK deals reflect distress sales. Highly geared groups may be required to raise funds at short notice. They are often compelled to accept a forced sale of a business to raise those funds. Management may be the only potential purchasers able to meet

26 Bryan de Caires, ed., *supra* note 15 at 15.
27 A Practical Guide to MBOs, *supra* note 1.
28 Bryan de Caires, ed., *supra* note 15 at 15.

a short time scale.

Fourthly, in many large corporate acquisitions a bundle of businesses are transferred. It is often the case that the purchaser is not really interested in all the businesses in the bundle, but has taken them all for simplicity. The managers in those ‘unwanted’ acquisitions may be well placed to buy their companies, not least because their new parent may have borrowed heavily to fund the larger acquisition and may also face constraints on management resources in attempting to integrate the businesses acquired.

Furthermore, in a receivership there is a tendency for managers to attempt a buy-out in order to simply preserve their jobs. This is never a sufficient reason to attempt a buy-out. Where the company or group has failed it must be clearly demonstrated that the underlying cause of failure can be redressed after the buy-out. Where a group of companies has gone into receivership it may well be possible to purchase one or more profitable subsidiaries.

In addition, a subset of the buy-outs arising from divergent shareholder aspirations is the increasingly common secondary buy-out. Institutional investors and, in some instances, members of a previous management buy-out team, may be seeking an exit from their investment. In such circumstances a re-organization of shareholdings is possible in which non-equity holding managers become shareholders and existing equity investments held by managers can be restructured to allow some of their locked-in gain to be realized.[29]

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[29] Ian Webb, ed., *Management Buyouts: A Guide for the Prospective Entrepreneur*, second ed. (London: Gower Publishing Company Limited, 1990) at 15.

Finally, in recent years there have been a significant number of public to private transactions. These involve the management of a quoted company making an offer for the shares of the company.

II. History and background of MBOs in China.

The past few years in China have witnessed an explosion of MBOs activity unlike that of any comparable period in recorded history. It started in 1997 as the first successful management buy-out transaction in China was implemented in Si Tong Group.[30]

However, the background of growth of MBOs in China is different from that in UK. China's ongoing economic reform towards a more mature free market economy is an important influence. Since 1999, a particular feature of recent Chinese experience has been the use of the management buy-out as a device to privatize or restructure the state-owned enterprises (SOEs)[31] and collectively-owned enterprises.[32] For instance, a variety of SOEs have been recently transformed into non state-owned enterprises through management buy-outs to realize the diversification of investment sources.[33]

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[30] Si Tong is a collectively-owned enterprise. In this case a shell company was incorporated by the Union of Share Holding Employee. For further discussion, see Chapter 5 II Types of present management buy-outs in China below.

[31] State-owned companies are a special category of companies; Article 64 of Company Law defines a wholly State-owned company as a limited company established solely by the State-authorized Investment Institution or by a department authorized by the State. See Online: <http://www.isinolaw.com/jsp/companylaw/CL_stateowncom.jsp?LangID=0>.

[32] This kind of organization is not a corporation incorporated according to the Company Law of the PRC. Due to historical reason, its ownership is not clear. It is in a state of confusion that who is the investor and who shall take responsibility in this organization.

[33] MBO of Hunan Dongting Aquaculture Co., Ltd,(website: http://www.hndtsz.com/main.htm) and Shandong Shengli Co., Ltd.(website: http://www.vicome.com/english/about/index1.asp).

Before looking to the special features of frequently-occurring management buy-outs in China, the case of the management buy-out of Holley Group[34] shall be discussed. The unorthodox management buy-out strategy at Holley Group is argued as a model for China's state-owned enterprise reform.[35] It is also deemed as a possible model for other Chinese collectively-owned enterprises which have been trying to privatize the ownership and convert themselves into standard companies by means of management buy-outs.

1. MBO of collectively-owned Holley Group and arising problem

A. Background of the MBO of Holley Group

Privatization is a nice idea, and for years foreign economists have urged China to embrace it. Inefficient state-owned and collectively-owned industries have been a drag on China's economy for too long. Governments believe that large-scale privatization through management buy-outs would bring higher productivity, accountability and would be best of all for local governments - fatter tax revenues. But even when local governments support a company's privatization plans, the mechanics of transferring any but the smallest of enterprises from state or collective ownership to private hands can be daunting.[36]

The country's market leader in sales of electricity meters to the power industry, Holley Group, based in Zhejiang province, and headquartered in nearby Hangzhou, had been trying to privatize since 1994. Its projected management-buyout scheme has been closely supervised

[34] Holley Group, online: <http://www.holleymeter.com/htmnew/index.htm>.
[35] Susan V Lawrence, "Back-door takeover", Far Eastern Economic Review, HongKong Aug 17,2000. Vol. 163, Iss. 33 at 42, 43.
[36] EMKT.com.cn, "Barrier of Conducting MBOs" (Feb 2003) Online: <http://www.emkt.com.cn/news/other/2003-02-26/6857.html>.

by provincial officials and state-enterprise administration as a possible model for other Chinese companies. No national guidelines exist for companies that want to privatize through management buy-outs. Therefore, companies like Holley and governments like Zhejiang's are forced to improvise, bend rules and privatize only in fits and starts.

Holley's tangled ownership structure goes back to the 1950s, when Chairman Mao Zedong called on entrepreneurs to join together to create small handicrafts cooperatives. In Zhejiang, three cooperatives that made pens, umbrellas and brooms were generated. Individuals made the initial investments to get the cooperatives up and running. In 1970, the state merged the three cooperatives into a single company and decreed it to be "collectively-owned". And according to the state, collectively-owned companies were owned by "all the labouring masses." Still with no input of state money, that company switched to mailing electricity meters the same year. Thirty years later, Holley's core business remains electricity meters, but it has expanded into copper sheeting, chemicals and real estate.[37]

Collective enterprises are owned by "all the labouring masses", as government policy remains unchanged. But according to the policy, it is still imprecise that who owns Holley. Is it owned by all the workers in this enterprise, or by all the workers in this industry, or by everybody? It needs to be clarified urgently because until ownership is clear, everyone says it is his property, but no one takes responsibility.

[37] Profits of Holley in 1999 were 297 million RMB ($25 million) on sales of r.5 billion RMB. Holley operates 16 factories and 26 sales companies in China. It holds controlling stakes in four other companies, including Chonqing Holley, which it bought in 1999 and is listed on the Shenzhen Stock Exchange. Holley also has an electricity-meter factory in Thailand and a controlling stake in another in Vilnius, Lithuania.

B. Management buy-out of Holley Group and Policy obstacles

One obvious way to clarify Holley's ownership might have been to return the company to the hands of the original entrepreneurs who set up the bamboo cooperatives. But most of them have died and it wasn't clear who had invested, or how much. Another way might have been to list Holley on a stock market. But national policy made it difficult as firms that want to be listed have to join a long queue for approval from relevant government departments. A third way to privatize would have been to have the managers buy the company outright. The factor in favour of Holley's MBO has been the support of its local government, which urged Holley to privatize in the first place, largely to create incentives for managers. The factor against Holley is the confusion one encounters everywhere in China about who owns state-owned and collective enterprises, and thus who has the right to sell them to private investors, and how to make the transaction legal.[38]

In 1995, Holley and its government backers finally ended up offering to "sell" a portion of the company's shares to all employees. While no shares were actually transferred to any employee, each was entitled to the dividends accruing on them. Employees could "buy" shares depending on their position in the company. Thereafter, the management wanted to buy all the shares back, paying employees a premium of 20% on their original investments, but some employees were unhappy to accept the buy-back offer.

[38] Holley's Vice-Chairman Li Yiqing, one of the few veterans of the bamboo cooperatives still with the company, says "pricing our assets was very difficult. If the price was too high, we managers wouldn't be willing to pay it. If the price was too low, the workers wouldn't go along. There was also the question of to whom any money should be paid. "

In 1999, management started over with a management buy-out. This time they registered a new company Zhejiang Holley Holding (Holley Newco). Shortly after the company's registration, each of the 129 managers all handpicked by Chairman Wang was required to buy from local government between 100,000 RMB worth and 5 million RMB worth of Holley Newco's shares depending on their positions. As stated later in Chapter 5, Type B of MBOs was utilized in this situation. However, no one had that kind of money. So they found a bank in Hangzhou that was willing to extend illegal three year loans to Holley's managers using the shares they planned to buy as part of the collateral. The loans were illegal because national policy doesn't allow borrowers to use shares as collateral.[39] Some also were illegal because national policy bans bank loans in excess of 500,000 RMB to individuals. In fact, Chinese banks rarely make loans to individuals.

C. Government turns a blind eye

"In reform, we often hit against policy obstacles," says Deputy Mayor of Hangzhou, Ma Huimin. "How are you going to leap across them? The government can only turn a blind eye and not discuss them."

The idea this time around was to give Holley's management team a big-enough stake and generous share options in the company to give them a strong personal interest in how the company performs. To make his purchase of 300,000 RMB worth of Zhejiang Holley shares, for example, public-relations director Qiu Xiaoping borrowed one-third of the sum from a

[39] See Chapter 5, III Legal problems arising in current MBOs below.

sister in New York and two-thirds from the bank, with his apartment and all his worldly possessions as part of the collateral. In the previous share buy-up, his stake had been just 20,000 RMB. “I didn’t really feel it then,” he says. “If the company failed, I’d have felt a bit of pain. But now, my home and all my assets are at stake. It feels very different.” One year later, Qiu’s shares and share options yielded him 120,000 RMB. “Everyone felt good at the end of the first year,” says Qiu. “One third is already paid off.”

Zhejiang Holley ultimately displaced the parent company as the majority shareholder in each healthy subsidiary. Holley’s Type B management-buyout model has drawn a lot of attention in China, feeding a hunger for ideas about how to move larger state and collectively owned businesses out of their murky ownership situations. Holley has hosted visits from interested provincial leaders and from other state-owned enterprises.

D. Conclusion

As a solution to China’s ownership confusion, however, the Holley plan has its shortcomings. It requires bank’s backing which is technically illegal. It rewards one set of hand-picked employees lavishly while denying the same riches to other loyal employees. And Holley’s tale says a lot about how far it is possible to take economic reform in today’s China.

2. China’s SOE reform and market opening-up

Advancing sustainable economic development is an important topic for all the countries in the world. Enterprises are the microcosmic foundations of economic and social development.

Stimulating the vigor of enterprises and keeping harmonious the relationship between enterprises' development and social development are the important guarantees for realizing comprehensive, coordinated and sustainable economic development. Since late 1970's, China, taking the market as the direction, SOE reform as the core task, has been incessantly pushing forward the economic system reform.

In China, the state-owned enterprise is an important composition of the economy and plays an essential role in economic growth, technology advancement and social employment.[40] However, due to historical reasons, a considerable amount of state-owned enterprises which were generated under a long-term socialist plan economy system and lack operational mechanisms of modern corporations but have redundant employees are unable to adapt to the market-oriented system.[41] Also, an old problem was left over from China's traditional system that the status of an investor in an SOE is not recognized. It is not clear that who has the rights and takes the responsibilities in a SOE. And except those important industries and key areas that have a vital bearing on the national security and the lifeline of the state economy which should be controlled by the state, the state economy still has its massive presence in other general competitive sectors and areas, such as processing industries and common service industries.[42] The problems in the state economy's layout and structure not only affect the quality and efficiency of the national economy, but also exert a negative impact on the national economy, and harm the deepening of the state-owned

[40] In 2002, the total assets of 159,000 state-owned enterprises and state holding enterprises have reached 18.02 trillion Yuan with 378.63 billion Yuan of profit, 679.41 billion Yuan of tax payment and 46.805 million employees. See State-owned Assets Supervision and Administration Commission of the State Council (SASAC), News Update, "Aggressively advance SOE reform and development: Enhance China's sustainable economic development and overall social progress, Li Rongrong, Chairman of SASAC", (7 November 2003), online: <http://www.sasac.gov.cn/eng/new/new_0008.htm>.

[41] "Resolution of the Communist Party's Central Committee on several important issues regarding the SOEs reform."(1999), online: <http://www.china.org.cn/chinese/archive/131784.htm>.

[42] *Ibid.*

assets management system reform and the reform of SOEs. [43]

As a result, a good environment of laws and policies must be created to encourage private capital to participate in the restructuring and renovation of SOEs to meet the needs of the SOEs reform and the adjustment of the layout and structure of the state economy.

3. Since China's SOE reform and market opening-up, MBO has been explored as one of the means and modes for harmonious combination of state ownership and market economy.

Since the topic of reform and opening-up proposed by the 14th National Congress of the Communist Party of China("CPC") in 1992, China has insisted on a market-oriented system, constantly deepened SOE reform, and actively explored means and modes for a harmonious combination of state ownership and market economy. Significant changes have taken place in SOEs' management system and operating mechanisms and strategic adjustment of the layout and structure of the state economy has made progress. Importantly, in order to accelerate the pace of establishing modern enterprise system, SOEs are pushed to convert themselves into standard companies and improve corporate governance in terms of a clarification of the ownership and the investors' rights and responsibilities, a separation of government functions of social and public administration from the functions of investors of state-owned companies, and an establishment of a scientific management mechanism.[44]

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[43] State-owned Assets Supervision and Administration Commission of the State Council (SASAC), News Update, "Continuously adjusted the layout and structure of China's state economy, propelling Chinese SOEs to participate in international competition and cooperation, Li Rongrong, Chairman of SASAC", (19 November 2003), online: <http://www.sasac.gov.cn/eng/new/new_0007.htm>.
[44] "Resolution of the Communist Party's Central Committee on several issues regarding establishment of a socialist market economy system."(1993), online: <http://www.china.org.cn/chinese/archive/131747.htm>.

Thereafter, at the 15th National Congress of the CPC held in September 1997, President Jiang Zemin outlined a programme which permitted, and perhaps opened wide the gates for, the sale of SOEs to private investors. The resolution of the CPC indicated that adjusting the layout and structure of the state economy strategically is the vital content of China's economic system reform. This adjustment will adapt to the main trend of the structural adjustment of the world industry and based on the guideline of "the state economy should enter into certain sectors while withdrawing from others, and focus on some business sectors while shrinking from others", China will optimize the layout and structure, strengthen the consolidation of resources and support and direct private capital to participate in SOEs' restructuring as strategic investors.[45]

Thus, a new pattern with state ownership playing a dominant role and diverse forms of ownership developing side by side has come into force and it is still being continuously improved. And since the encouragement of the CPC's resolution, a variety of SOEs have been transformed in non state-owned entities by virtue of management buy-outs.

Later, the CPC's 16th National Congress held in 2002 called for the great target of taking the rationalization of the state economy's layout and structure as an essential factor for the deepening of the economic system reform. The purpose of the convention to pursue the diversified forms for effectively realizing public ownership and intensify efforts to develop a mixed sector of the economy in which the state capital, collective capital and non-public capital all participate, boosted the development of the MBO concept in China. At the same time, this convention

[45] "Resolution of the Communist Party's Central Committee on several important issues regarding the SOEs reform."(1999) See online: <http://www.china.org.cn/chinese/archive/131784.htm>.

intended to establish and develop the modern property right system with clear ownership, rights and responsibilities, strict protection and smooth liquidation, protect various forms of property rights according to law, and fully evolve the rule of property rights' transaction and its regulation system.[46]

In order to reform the state-owned assets management system, according to the State Council's Institutional Reform Scheme approved at the first session of the 10th NPC of the People's Republic of China, the State Council set up the State-owned Assets Supervision and Administration Commission("SASAC"), and promulgated and implemented the Interim Regulations on Supervision and Management of State-owned Assets of Enterprises.[47] The establishment of SASAC realizes the separation of government functions of social and public administration from the functions of investor of state-owned assets at the government level for the first time and realizes the combination of regulation of assets, personnel and affairs, which is an important breakthrough in China's economic system reform and marks a new stage of SOE reform and development. The deepening of the state-owned assets management system reform, especially the clarification of the state-owned assets' investor, creates sound external conditions for SOE reform and development and sets more urgent requirements for accelerating SOE reform.[48] Taking the opportunity of reforming the state-owned assets management system, a great deal of state-owned companies has been involved in

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[46] State-owned Assets Supervision and Administration Commission of the State Council (SASAC), News Update, "Continuously adjusted the layout and structure of China's state economy, propelling Chinese SOEs to participate in international competition and cooperation, Li Rongrong, Chairman of SASAC", (19 November 2003), online: <http://www.sasac.gov.cn/eng/new/new_0007.htm>.

[47] See Chapter 5, I Overview of the present legal regime of Chinese law, below.

[48] State-owned Assets Supervision and Administration Commission of the State Council (SASAC), News Update, "Aggressively advance SOE reform and development: Enhance China's sustainable economic development and overall social progress, Li Rongrong, Chairman of SASAC", (7 November 2003), online: <http://www.sasac.gov.cn/eng/new/new_0008.htm>.

management buy-outs.

According to the Chinese policy improvement for SOE reform, SASAC would bolster the external regulation on its enterprises from several aspects, such as solve the old problem left over from China's old system that the status of an investor in an SOE was not recognised, and push forward the reform and restructuring of the supervised enterprises including the establishment of modern enterprise system in SOE, the perfection of corporate governance, stimulate the internal change and the transformation of operating mechanisms, separate the non-core business from the core business in order to sharpen the core business.[49]

As a result, accelerating the pace of establishing modern enterprise system, MBOs are one of the prominent instruments that can be used to push SOEs to convert themselves into standard companies, improve corporate governance, facilitate qualified SOEs to introduce the diversification of sources of investment, and explore various forms of effective incentives and restraint mechanisms for enterprise managers.

Early in April 2003, Mr. Jia Chan, head of the Enterprise Section of Ministry of Finance("MOF") said that the MOF would concentrate on the promulgation of management rules for management's acquisition of Listed Companies.[50] It was also noticed that the

[49] State-owned Assets Supervision and Administration Commission of the State Council (SASAC), News Update, "SASAC will reinforce the external regulation on its enterprises from five aspects, Shao Ning, vice chairman of SASAC" (23 September 2003), online: <http://www.sasac.gov.cn/eng/new/new_0005.htm>.

[50] O'Melveny & Myers LLP, China Law & Policy Digest(30 April 2003), (China Securities(zhong guo zheng quan bao), April 22, 2003), "Ministry of Finance (MOF) to Perfect Financial Systems through Promulgation of MBO Management Rules for Listed Companies." online: <http://www.omm.com/webdata/content/publications/clp030430.pdf>.

SASAC is studying laws and regulations pertaining to management buy-outs.[51]

Such supportive policies and law improvement gave rise to a development of MBOs in China, and MBOs become more and more necessary for being an effective method of property rights reform. Although law relating to MBOs can be drawn from some areas, the government tries to, on a continuous basis, improve and streamline the regulatory structure for MBOs. This will be discussed later in Chapter 5.

III. Brief Comparison of MBO phenomena in UK and China

Generally, the nature and extent of MBO phenomena varies considerably in the U.K. and China.

First, MBOs in U.K. based on the agency cost theory is utilized to increase the efficiency of corporate mechanisms. Most management buy-outs in the U.K. come from corporate restructuring including large companies or groups disposing non-core subsidiaries, privatizations of stated-owned entities, distress sales, managerial takeovers of family-run firms or private companies and public to private transactions. The MBO has been explored in China as one of the means and modes for establishing modern enterprise system. MBOs are a major device for collectively-owned enterprises to clarify the ownership and for state-owned enterprises to convert themselves into standard companies, to introduce the diversification of sources of investment, and explore various forms of effective incentives and restraint

[51] O'Melveny & Myers LLP, China Law & Policy Digest (21 November 2003) "SACSAC is studying Laws and regulations regarding MBO methods" online: <http://www.omm.com/webdata/content/publications/clp031121.pdf>.

mechanisms for enterprise managers.

Second, in the overwhelming majority of UK MBOs, management teams acquire a substantial equity holding and obtain an actual or potential majority of the voting shares.[52] Due to the insufficient wealth of the management team, and undeveloped capital markets, it is difficult for management teams to obtain substantial equity holding in China.[53]

Third, China's central government and local governments play dual roles in MBOs. On the one hand, they are the vendor in a MBO of SOE, on the other hand they are law-makers who will supervise such transactions. However, the government in the U.K. seldom intervenes in the conduct of MBOs.

Fourth, pricing of illiquid state-owed shares and corporate shares in MBOs are only based on net assets values in the balance sheet.[54] This is not the case in the U.K. where pricing is based on the combined consideration of net assets value, earning basis and others[55]

Finally, the development of the MBO business in the U.K. has been accompanied by an increase in the number and size of financing institutions and in the scope of the services they offer. But China has an undeveloped capital market. The industrial banks' service is restricted in both debt finance and equity investments, and the venture capital market in China, unlike

52 Bryan de Caires, *supra* note 15 at 14.
53 See Chapter 5, II Types of the present management buy-outs in China, below.
54 See Chapter 5, III 4 Pricing of management buy-outs in China, below.
55 See Chapter 4 and 5, below, for separate discussion on pricing in UK and China.

the U.K. is at an early stage of development.

Although the market for management buy-outs in China lags considerably behind development in the U.K., it is beginning to become an important innovation in China's economic reform. However, in spite of the issuance of several supportive rules and regulations pertaining to MBOs over the past years, there remain quite a lot of obstacles and risks when conducting the deals under the Chinese legal regime. Thus, to examine the principal legal issues concerning MBOs in the U.K. and those in China is of importance.

Chapter 4: Legal issues of MBOs in UK

Management buy-outs often involve numerous, complex legal issues and problems. Of particular importance is the risk that members of the buy-out team may be in breach of their contractual and fiduciary duties to the company (e.g. conflict of interest and confidentiality). Also, the offer letter which must be carefully drafted and may well include the seller's consent to disclosure of confidential information, its undertaking not to offer the company to another purchaser for a period and its agreement to assisting with the costs.

I. Director's duties at Common Law and other statute rules

Clearly, management teams will have their personal interests to consider in carrying out a management buy-out. The fairness of a buy-out for the shareholders has attracted much criticism, focused on the potential conflict between the fiduciary duties of the members of the buy-out team to selling shares or assets of a company on the one hand and their own personal aspiration as buyers on the other hand. Because the management team has access to inside information, it has the ability to affect the share price of the target company and consequently its valuation. The resultant opportunity for manipulation has created a fundamental concern that the management team may be benefiting from an opportunity which properly belongs to the company and its shareholders. These concerns about conflicting interests, inside advantages and misappropriation of corporate opportunities impose a much higher standard of fiduciary duty than will be required in normal transactions.

Hence, before making or entertaining a possible management buy-out, each proposed member of the buy-out team must analyze his legal position in relation to the companies of which he is a director or employee and their shareholders. The buy-out team must carefully consider their fiduciary duties at common law, their contractual obligations, and statutory constrains and obligations. Regulatory constraints and obligations imposed by the listing rules of the London Stock Exchange(“Listing Rules”) and the City Code on Takeovers and Merges(“City Code”) will be discussed separately.

1. To whom are the duties owed

A. Company and individual shareholder

Before turning to the specific common law duties, it is necessary to consider to whom such duties are owed. Clearly, common law duties of directors are owed to the company of which the person is a director.[56] Therefore, where the management buy-out takes the form of a

[56] Paul L. Davies, Gower and Davies’ Principles of Modern Company Law, 7th ed. (London: Sweet & Maxwell

purchase of the business of a company one would clearly have to consider whether the actions of the directors of that company in the conduct of the buyout amount to a breach of any of those duties. However, where the buyout is of the shares in the directors' company the issue is not so clear because the precise extent of a director's duty to the shareholders of his company is unclear, and there is a question whether shareholders can bring litigation against the directors in such circumstances.[57] In addition, following completion of the buyout, the ownership and control of the target company to which the directors owe duties will have passed to the directors and their funders through a formed Newco. Thus, once the vendor has agreed to the principle of a management buyout of its shares, it will, practically speaking, be impossible for the shareholders to cause the company to pursue any remedy against the management team.[58]

The doctrine of shareholder protection, both as regards fiduciary duties owed and the misappropriation of corporate opportunity, does not deal satisfactorily with the issues. The leading case *Percival* v. *Wright*[59] is generally accepted as authority for the proposition that the directors of the company only owe a fiduciary duty to the company, not to the shareholders.[60] On the basis of this rule it has been recognized that there is no obligation on a director to disclose even highly material price-sensitive information that he has learnt by virtue of his

Ltd, 2003) at 371.

[57] *Ibid*. at 374.

[58] Maurice Dwyer, *Private Equity Transactions*, looseleaf (London: Sweet & Maxwell, 2003) at 1.03.

[59] See *Percival* v. *Wright* [1902] 2 Ch. 421.

[60] In this case a director of a company bought shares from a shareholder at a price less than that for which the director knew that a third party had expressed interest in. The latter proposal came to nothing, but the selling member sued the director for breach of fiduciary duty to the member in not disclosing the interest expressed by the third party. Lord Swinfen Eady J. drew a clear distinction between the directors' fiduciary duty to act in the best interests of the company and the plaintiff's contention which he strongly rejected that the directors held a fiduciary position as trustees for the individual shareholders. Accordingly, he rejected the claim, holding that the purchasing director was under no obligation to disclose to the vendor shareholders the negotiations which ultimately proved abortive.

office to a person with whom he deals in regard to the shares of his company.[61]

Moreover, the Scottish Court of Session case of *Dawson International plc* v. *Coats Paton plc and others*[62] confirms that there is no secondary general fiduciary duty owed by directors to shareholders of their company.[63]

Although, the rule established in *Percival* v *Wright* remains as the basis of UK law relating to directors' duties, it has been criticized over the years that it should not be inferred that directors can never stand in a fiduciary relationship to the individual shareholders. It was criticized not because it was based on the ground that a director's fiduciary duties are owed to the company and not to individual members, but because the application of that doctrine in those circumstances led to a supposed unfairness which ultimately led to the enactment of legislation against insider trading.[64]

The decision has stood for almost a century without being overruled in UK or not followed

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[61] "Insider Beware" (Case Comment on Percival v Wright), COMPLAW 1993, 14(11), 202.

[62] See *Dawson International plc* v. *Coats Paton plc and others* [1989] B.C.L.C. 233.

[63] The case concerns an alleged agreement between a bidder for a listed company and the company itself that the company would recommend the bidder's offer and not seek or co-operate with alternative bidders for its shares. The bidder alleged that the company had breached the agreement when the company co-operated with a subsequent rival bid which resulted in an agreed takeover of the company being announced. The case included an action against two of the directors of the company for reimbursement of the expenses that the bidder had incurred in taking steps to implement arrangements for what ultimately was an aborted bid. Lord Cullen rejected the company's and directors' argument that the alleged contract would have been contrary to a general fiduciary duty that the directors of the company owed to individual shareholders to advise them on the merits of any takeover bid. He was careful to distinguish between directors' fiduciary duties to the company itself and the absence of any general fiduciary duty owed to shareholders. However, Lord Cullen confirmed that directors could put themselves in a position where they have a duty directly to shareholders.

[64] Tom Bostock (Partner, Mallesons Stephen Jaques of Melbourne), "Director's Duties: Recent Developments and Their Implications for Directors and Advisers: To Whom Are the Duties of a Company Director Owed?" Australian Institute of Company Directors and Center for Corporate Law and Securities Regulation(the University of Melbourne) Seminar, November 8 2000, unpublished, online: <http://www.aic.gov.au/publications/lcj/casino/ch2.html>.

elsewhere in the Commonwealth, except by the New Zealand decision in *Coleman* v *Myer*.[65] Mahon J at first instance refused to follow *Percival* v *Wright* stating that the rule of fiduciary duties towards the shareholders should be confined to private companies and to such transactions in public company shares where the identity of the shareholder is known to the director at the time of sale. The New Zealand Court of Appeal emphasized that even in the absence of agency, a fiduciary duty arose in the case of a small family company where there was a gross disparity of knowledge between the directors and the shareholders and where the shareholders had relied on the directors for information and advice.[66] When the directors negotiated with the shareholders for the purchase of their shares and were apparently not acting on behalf of the shareholders, they were nevertheless held to be subject to a fiduciary duty of full disclosure of relevant facts about the company to the shareholders.

Coleman v *Myer* was also acknowledged in Australia by Handley JA in delivering the judgment of the New South Wales Court of Appeal in *Brunninghausen v Glavanics.*[67] After an extensive review of the decided cases since 1902, Handley JA concluded that while the general principle that a director owes fiduciary duties to the company and not to shareholders

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[65] See *Coleman* v *Myer* [1977] 2 N.Z.L.R. 225. In the Supreme Court Mahon J had held the *Percival* v *Wright* was wrongly decided but the Court of Appeal distinguished it. 'In the present case, which is the case of a private company with unlisted shares, it seems an untenable argument to suggest that the shareholders on an offer to buy their shares are not perforce constrained to repose a special confidence in the directors that they will not be persuaded into a disadvantageous contract by non-disclosure of material facts. [T]here is inherent in the process of negotiation for sale a fiduciary duty owing by the director to disclose to the purchaser any fact ... which might reasonably and objectively control or influence the judgment of the shareholder in forming the decision in relation to the offer.'

[66] *Ibid*. at 325, 330.

[67] See *Brunninghausen* v *Glavanics* (1999) 46 NSWLR 538, CANSW. Handley JA acknowledged that "The general principle that a director's fiduciary duties are owed to the company and not to shareholders is undoubtedly correct, and its validity is undiminished." In Brunninghausen, the company had two shareholders who were both also its only directors. After a falling out, the claimant ceased to take part actively in the management of the company's business. Subsequently, the active director and majority shareholder agreed to buy out the claimant's minority shareholding without disclosing that he was in negotiations for the sale of the company's entire business. The sale of the company's business was concluded shortly afterwards at a price valuing the shares at over 10 times the sum which the claimant received for them.

remains valid, the decision of a single judge in *Percival* v. *Wright* should not be allowed to stand in the way of the recognition of such a duty at this time.[68]

Although, the decision in *Percival* v. *Wright* is one of a corpus of cases from the Victorian and Edwardian eras that has cast a long shadow over the development of company law in general and the law of directors' obligations in particular,[69] the law relating to director's fiduciary duties towards the company's shareholders in UK is at present in a developing state.[70] Two recent cases *Platt* v. *Platt*[71] and *Peskin* v. *Anderson*[72] continue a series of judgments that justify the imposition of fiduciary duties on directors to individual shareholders in special circumstances.[73]

The principle that a duty of some sort can be owed by the director to the shareholder has now been fully accepted in English Law as a result of decision of the English Court of Appeal in *Peskin* v. *Anderson*,[74] where Mummery L.J. distinguished clearly between the fiduciary duties owed by directors to the company and fiduciary duties owed to shareholders which are dependent on establishing a special factual relationship between the shareholders and

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[68] Handley JA stated the question in *Brunninghausen* as being "whether the principle applies in a case, such as the present where the transaction did not concern the company, but only another shareholder." "the decision of a high judge in Percival v Wright should not stand in the way of recognition of ….[a] fiduciary duty owed by directors to shareholders where there are negotiations for a takeover or an acquisition of the company's undertaking [that] would require the directors to loyally promote the joint interests of all shareholders. A conflict could only arise if they sought to prefer their personal interests to the joint interest."

[69] "The Latest Rites for *Percival* v. *Wright*" Case Comment on *Brunninghausen* v *Glavanics*, COMPLAW 2000, 21(9), 261.

[70] Demetra Arsalidou, "Directors' Fiduciary Duties to Shareholders: the *Platt* and *Peskin* cases" Case Comment, COMPLAW 2002, 23(2), 61-63.

[71] See *Platt* v. *Platt* [1999] 2 B.C.L.C. 745, Chd.

[72] See *Peskin* v. *Anderson* [2000] B.C.C. 1110; [2000] 2 B.C.L.C. 1, Chd.

[73] Demetra Arsalidou, *supra* note 70.

[74] *Peskin* v. *Anderson* involved the demutualization by a scheme of arrangement of the Royal Automobile Club. Following this, the business was eventually sold and the members realised over £34,000 each for their shares. The claimants were former members of the Club and former shareholders who began proceedings against the directors seeking damages for breach of a fiduciary duty to disclose the plans relating to the demutualisation.

directors in particular case.[75]

In *Platt* v. *Platt* which involved a family company,[76] David Mackie Q.C. effectively followed the reasoning in *Coleman* v. *Myers,* to the extent of holding that a fiduciary duty to the shareholders was owed and breached. He noted that the facts of *Coleman* v. *Myers* bear a resemblance to those in this case. He held that while the relationship between a director and shareholder does not of itself give rise to a fiduciary duty, this does not prevent such an obligation arising when the circumstances require it, and a fiduciary duty was imposed on the director which obliged him to disclose to his brothers shareholder matters which he knew or had reason to believe would be material to their decision to transfer their shares.[77]

Overall, despite the recent significant development in English Law, the general proposition that a director's primary fiduciary duty is owed to the company remains. An exception arises where a special factual relationship between the shareholders of the company and the directors exists, which is capable of triggering fiduciary obligations to shareholders. In the absence of a special relationship, directors do not owe a fiduciary duty to the shareholders of the company to keep them constantly informed of all information that might affect their position. Thus, the duty may arise where directors, through negotiations or dealings, are

[75] Paul L. Davies, *supra* note 56 at 374.

[76] In *Platt*, three brothers were shareholders in a company which held a BMW dealership. The defendant ran the business and held ordinary shares. The claimants were the two other brothers who did not work in the business and held redeemable preference shares. In 1992, when the company became financially weak, the defendant recommended to the claimants that they transfer their preference shares to him for £1. The claimants alleged that they were warned that the transfer was necessary because of the financial position of the company to enable the business to be sold at the insistence of BMW. They were also told that, if the sale did not eventually happen, the shares would be returned. When the company's financial position improved, BMW did not require the business to be sold and the claimants asked their brother to retransfer the shares, which he refused to do. In 1996, the business was sold and the claimants began proceedings seeking damages for breach of contract, misrepresentation and breach of fiduciary duty.

[77] *Platt*, *supra* note 71

brought into close contact with the shareholders, or a relationship of trust and confidence exists between the directors and the shareholders.[78] However, it is suggested that the exception is essentially for family or small companies and does not significantly reduce the significance of the general proposition within large shareholder bodies.[79]

B. Creditors and employees

It should also be borne in mind that directors owe duties both to creditors (in cases where the company is insolvent) and employees. The case of *West Mercia Safetywear Ltd* v. *Dodd*[80] illustrates the former duty where it was held that once a company was insolvent the interests of the creditors overrode those of the shareholders since the company's assets belonged to the creditors who could displace the power of the shareholders and director to deal with the company's assets upon liquidation.[81]

With regard to the duty to employees, section 309 of the Companies Act 1985 makes clear that directors are to have regard to the interests of the company's employees in general as well as to the interests of its members in the performance of their functions. Under that, the matters to which the directors of a company are to have regard in the performance of their function include the interests of the company's employees in general, as well as the interests of its members. However, subsection (2) of section 309 provides that: "Accordingly, the duty imposed by this section on the directors is owed by them to the company (and the company

[78] Demetra Arsalidou, *supra* note 70.
[79] Paul L. Davies, *supra* note 56 at 376.
[80] See *West Mercia Safetywear Ltd* v *Dodd* [1988] B.C.L.C. 250.
[81] This is the rationale contained in the dictum of Street C.J. in *Kinsela* v *Russel Kinsela Pty Ltd* (in liq.) (1986) 4 N.S.W.L.R. 722 at 730.

alone) and is enforceable in the same way as any other fiduciary duty owed to a company by its directors", which means enforcement by the company and that the employees as such have no or very limited means of enforcing it.[82] The practical effect of section 309 seems to be not to give an employee a direct remedy against defaulting directors.[83] Indeed, it may be that one effect of section 309 is to dilute director's accountability to shareholders rather than to strengthen their accountability to employees.

2. Conflict of interest and fiduciary duties

Whether or not directors owe duties to their companies' shareholders, they clearly owe duties to their company which will be relevant in the period leading up to completion of the buyout. Furthermore, if the buyout takes the form of a purchase of the business and assets of Target, rather than its shares, such duties may remain of relevance during and following completion. Such duties have been described as being in the nature of fiduciary duties.

Under UK principles, there are four major categories of fiduciary duty.[84] First directors must exercise their powers for a proper purpose.[85] Second, the directors must not fetter their discretion to exercise their power. Third, they must act in good faith in what they believe to be the best interests of the company. Fourth, they must not place themselves in a position where

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82 See *Dawson International*, *supra* note 62 at 243

83 See e.g. *Re Saul D. Harrison* & *Sons Plc* [1995] 1 B.C.L.C. 14, CA, where s.309 was prayed in aid to undermine the shareholder petitioning under s. 459 against the board/majority shareholders of the company. There is nothing wrong with such use of s.309, but it means that employees will benefit from it only to the extent that their interests are aligned with those of the board, which will not necessarily be the case.

84 Paul L. Davies, *supra* note 56 at 381.

85 In *Piercy* v *Mills & Co. Ltd.* [1920] 1 Ch. 77, it was held that the allotment of the shares by existing directors to supporting shareholders to dilute the voting right of the majority shareholder was found to be improper exercise of power.

the duties of their office and their personal interests conflict.[86] For management buy-outs, directors not only have a duty to act honestly but also have various fiduciary duties, based on the basic concept that they must act in the best interests of their company, and the most relevant of these duties is often expressed as a duty not to make a secret profit from one's position.[87]

The management team will face legal conflicts of interest from the moment they start to consider a buy-out. All directors are bound by fiduciary duties at all times to act in good faith in the best interests of the company of which they are directors. It is described as the "core duty" of directors, because it applies to every decision which the directors take whether or not there is an operative conflict of interest.[88] This general principle is expressed in the famous guiding statement of Lord Greene in *Re Smith* v *Fawcett Ltd*.: '[W]here the articles of a company confer a discretion on directors… [t]hey must exercise their decision bona fide in what they consider-not what a court may consider-is in the best interests of a company, and not for any collateral purpose.'[89]

However, it should be noted that the duty to act bona fide in the interests of the company is a

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[86] In *Regal (Hasting) Ltd.* v *Gulliver* [1942] 1 ALL E. R. 378, the directors had to account for the profits made when they sold the shares of their subsidiary company to their company they were working in.
[87] Maurice Dwyer, "Legal Aspects of Management Buy-outs", ICCLR 1995, 6(4), 129-134.
[88] Paul L. Davies, *supra* note 56 at 387.
[89] See *Re Smith* v *Fawcett Ltd*. [1942] Ch. 304 at 306. In this case, one of the two shareholders and directors (also acting as executor) refused the son of the deceased for registration of share transfer, unless the latter sold the shares to the former. It was held that the director had exercised the powers in the interests of the company. For early statements, see Charitable Corp. v. Sutton, 2 Atk. 400, 406 (1742) ('[B]y accepting of a trust of this sort, a person is obliged to execute it with fidelity and reasonable diligence') and Re Forester Dean Coal Mining Co. (1878) 10 Ch. D. 450. ('Directors have sometimes been called trustees, or commercial trustees, sometimes they have been called managing partners; it does not matter much what you call them as long as you understand what their true position is, which is really that they are commercial men managing a trading concern for the benefit of themselves and all the other shareholders…They are bound to use fair and reasonable diligence in the management of the company's affairs and to act honestly.'

subjective duty, i.e. it is up to the directors not the court to identify what is in the best interests of a company. Even where the director has not acted as an honest person, this is not necessarily a demonstration of a breach of the duty of good faith. In a recent case,[90] where the directors' decision had caused substantial harm to the company, it was held that this was merely a piece of evidence against their contention that they acted in good faith rather than absolute proof that they had not acted so. Thus, this duty is simply to display subjective good faith.[91]

Practically, management teams and ventures capitalists may point to the following factors as evidence that management buy-outs are in the best interest of the company. In these circumstances, it is hardly surprising that it is very difficult to show that the directors have broken their duty of good faith. First, it can be argued that the financing structure of management buyouts often results in a lower overall cost of capital. Second, management often argue that their deal is best for the company in its widest sense including the interests of its creditors and employees such as that they may argue a competing trade buyer of the business, although it might have been prepared to offer more money, would fairly quickly rationalize the business, close down divisions, reduce levels of business with suppliers and make employees redundant. On the other hand, management will argue, their deal will ensure the future stability of the business along existing lines and thus be in the better interests of creditors and employees. Third, management may hold that management buy-outs are safer because the businesses involved are already established in their methods and under the control

[90] See *Regentcrest Plc (in liquidation*) v *Cohen* [2001] 2 B.C.L.C. 80.
[91] Paul L. Davies., s*upra* note 56 at 388.

of experienced management. Fourth, a management buy-out may be preferable to a sale to a competitor of the business, both in terms of maintaining a competitive market and facilitating a sale without dispersing valuable commercial information amongst competitors of business in question, etc. Accordingly, it should be noted that, provided the directors genuinely consider a management buyout to be in the interests of the target, the fact that the buyout may also benefit them does not mean that they will be in breach of this fiduciary duty.[92]

In addition to act bona fide, directors must exercise their powers for a proper purpose. It is clear that, notwithstanding that directors have acted honestly for what they believe to be the benefit of the company, they may nevertheless be liable if they have exercised their powers for a purpose different from that for which the powers were conferred upon them.[93] Perhaps, the greatest puzzle in this area is to know by which criteria the courts judge whether a particular purpose is proper. This is generally stated to be a matter of construction of the articles of association.[94] Hence, the test is an objective one, even if it is applied to the directors' subjective motivations.[95]

Perhaps the most relevant of the directors' common law duties in management buyouts is the duty of a director not to put himself in the position where his personal interests and his duty to the company may conflict. Examples of this duty are that a director must not make a secret profit out of his position nor must he benefit from an opportunity which properly belongs to

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92 Maurice, Dwyer, *Private Equity Transactions*, *supra* note 58 at para. 1.09.
93 See *Howard Smith Ltd* v *Ampol Ltd* [1974] A.C. 821 at 834, PC.
94 See *Re Smith*, *supra* note 89 at 306.
95 Paul L. Davies., *supra* note 56 at 386.

the company. *Cook* v. *Deeks*[96] establishes that directors shall account for profits if they use their position to divert to themselves an opportunity. *Regal (Hastings) Ltd* v. *Gulliver*[97] and *Industrial Development Consultants Ltd* v. *Cooley*[98] establish that directors may have to account for profits even if they have acted in good faith and the company is commercially unable to exploit the opportunity. *Fine Industrial Commodities Ltd* v. *Powling*[99] is authority for the proposition that directors may have to account even though the company is legally unable to exploit the opportunity. There are many more cases in this area illustrating particular aspects of this duty and a detailed consideration of them is unnecessary in the context of a consideration of how management who are directors should properly conduct themselves in the period of negotiation leading up to conclusion of their buyout.

Management should not proceed with a management buy-out without prior discussion with and the consent of the board of directors of the Target and the vendor, otherwise they may risk liabilities at law. In practice, it is likely to be required by management's financial backers. Accordingly, managers should notify Target's directors and the vendor of their proposal and request written permission to prepare a business plan and to disclose the business plan and other relevant agreed information to advisors and potential investors.[100]

Provided that the principle of the buyout has been agreed with Target's shareholders, the proper discharge of management's duties in this area can usually be effected if management

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[96] See *Cook* v. *Deeks* [1916] 1 A.C. 554.
[97] See *Regal (Hastings) Ltd*, *supra* note 86.
[98] See *Industrial Development Consultants Ltd* v. *Cooley* [1972] 1 W.L.R. 443.
[99] See *Fine Industrial Commodities Ltd* v. *Powling* [1954] 71 R.P.C. 253.
[100] Niall McAlister, *supra* note 3.

provide full information to Target's shareholders and if Target, acting independently of the directors (either through its shareholders or an independent board or committee) approves the action taken by the management directors. If these requirements are fulfilled, a director will be able to participate in investment opportunities and transactions belonging to the company, and the fact that such participation happens to occur in the context of a management buyout should not adversely affect management's legal position.

3. Duties arising out of service agreements and contractual arrangements

Before looking to the fiduciary duties of directors under common law or statutory duties, a vendor may first examine the employment contracts of directors because usually, managers contemplating a buy-out will have service agreements or employment contracts containing express or implied contractual obligations.[101] Thus, a director's fiduciary duties will normally be supplemented in his service agreement, which will underline the director's duty to act bona fide in the best interests of the company and to act for proper purpose.

Most senior employees' contracts are also likely to include "whole time and attention" clauses under which they are likely to have contractual obligations to spend the whole of their time and attention on their employer's business and to act in its best interests.[102] Clearly it will be a breach of such duties to be spending some of the time that he should be devoting to the business of his employer in meeting and discussing with potential funders of the buy-out. Although these duties are unlikely to preclude them from discussing a potential buy-out

[101] Maurice Dwyer, *Private Equity Transaction, supra* note 58 at para. 1.31.
[102] Maurice Dwyer, "Legal Aspects of Management Buy-outs", *supra* note 87.

during their personal time making use of their own facilities and property, preparatory activity may however still amount to a breach by the manager of his duty of fidelity towards his employer.[103]

Senior employees are also likely to have restrictive covenants which will prevent them from taking any action which could damage their employer's business. This contractual duty prevents employees from entering into direct competition with the employer, from talking to customers, suppliers or other employees as to whether they would be supportive of a management buy-out, and from assembling a management team.[104]

It can be seen, therefore, the act of talking to colleagues or to funders or professional advisers may constitute a breach of either or both of the manager's common law or contractual obligations. If an employer learns of any serious breach by a director or employee of the duties, it can obtain an injunction from the High Court restraining the employee from committing further breaches. And this may entitle an employer to dismiss a manager summarily and without compensation and to have legal remedies against a director who take steps to launch a buy-out.[105]

In these circumstances, managers are often in a dilemma that they will need to obtain expert advice as to whether or not their buy-out is viable and need to present funders with a well rounded management team, which involve their talking to their colleagues. This dilemma can

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[103] Maurice Dwyer, *Private Equity Transactions*. *supra* note 58 at para. 1.32.
[104] Debbie Anthony, *supra* note 11 at 81.
[105] Maurice Dwyer, "Legal Aspects of Management Buy-outs", *supra* note 87.

only be overcome where the employer is amenable to the prospect of a management buy-out and waives its right to require compliance by the employee. If the employee keeps the employer informed of his proposed course of action before taking it and the employer consents to this action, the company will not be able to argue subsequently that the employee was in breach of his duties to the company.[106] Therefore, it is essential for that prudent management shall ensure that they have squared their position with their employer before taking any real steps to pursue a buy-out which may potentially amount to a breach of their common law or contractual duties.

4. Confidentiality provisions in service agreements and the initial approach to funders and advisors.

It is, in fact, the confidentiality obligations in service agreements or employment contracts which can cause most difficulty to a director who wishes to plan a management buy-out. In many cases management may have service contracts which normally contain an express provision requiring them not to disclose or use confidential information belonging to the employer company either during the contact of employment or after its termination. This restriction gives the members of the buy-out team problems because these obligations will expressly prevent the director from providing his potential funders and outside advisers with the financial information on which they need to assess whether or not buy-out is feasible.[107] Breach of confidentiality obligations in service agreement can relatively easily be enforced by employers by way of injunction.

[106] Debbie Anthony, *supra* note 11 at 81.
[107] Maurice, Dwyer, *Private Equity Transactions, supra* note 58 at para. 1.34.

In the absence of any express contractual duties, an employee will be under an implied duty not to use or disclose certain information confidential to the employer during the course of his employment and trade secrets following the termination of the employment. In the leading case of *Faccenda Chicken Ltd* v *Fowler*[108], the Court of Appeal determined that information of a highly confidential nature, such as details of a secret process, could never be divulged by an employee either during his employment or after its termination. The court then identified, as a second category, information which an employee should treat as confidential either because he has been expressly told that it is confidential or because, from its character, it is obviously confidential.

However the court stated that the implied term which imposes an obligation on the employee as to conduct after the determination of the employment is more restricted in its scope than that which imposes a general duty of good faith. It is clear that the obligation not to use or disclose information may cover secret processes of manufacture and other information which is of sufficiently high degree of confidentiality as to amount to a trade secret. The obligation does not extend to cover all information acquired by the employee while in his employment. This distinction is clearly set out in *Printers and Finishers Ltd* v. *Holloway*[109] that not all information which is given to a servant in confidence and which it would be a breach of his duty for him to disclose during his employment is a trade secret which he can be prevented from using for his own advantage after the employment is over, even though he has entered

[108] See *Faccenda Chicken Ltd* v *Fowler* [1987] Ch 117, [1986] I.C.R. 297.
[109] See *Printers and Finishers Ltd* v. *Holloway* [1965] 1 W.L.R. 1; [1965] R.P.C. 239.

into no express covenant.[110]

The more recent case of *Brooks* v. *Olyslager OMS(UK) Ltd*[111] also supported the distinction between current and former employees. In this case, the information that a company was insolvent and its budgets were too optimistic was not of a sufficiently confidential nature to warrant protection post-termination by an implied term. The position might have been different had there been expression provisions in the contract. For these reason, an employer can usually stop the employee using or divulging such information after the termination of the contract if it is specifically entitled to do so by virtue of express provisions in the employment contract.[112]

A company will therefore be able to restrain its directors and employees from making use of confidential information during the course of their contracts of employment, whether or not there is an express contractual stipulation regarding confidential information.

However, a company can only act to protect information so long as its nature remains confidential. As soon as the information is in the public domain, no action for breach of confidence can be brought. Further, if the information is already in the possession of several other people, even if not available to the general public, it may nevertheless cease to be described as confidential.[113] If a company is able to establish that certain categories of

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[110] See also *E. Wousley & Co. Ltd* v. *Cooper* [1939] 1 ALL E.R. 290.
[111] See *Brooks* v. *Olyslager OMS(UK) Ltd* [1998] I.R.L.R. 590, CA.
[112] Maurice, Dwyer, *Private Equity Transactions*, *supra* note 58 at para. 1.35.
[113] See *Coco* v *AN Clark (Engineers) Ltd.* [1969] RPC 41. In this case, the relevant company had made available to 43% of its shareholders certain information regarding a take-over proposal. It had also entered into confidential

information are confidential and can be protected, it can only seek to restrain a director or employee from using that information provided it can show that unauthorized use had caused or will cause the company some detriment[114].

It is common for management to make the initial approach to a prospective funder of a buy-out and discuss with a professional adviser for the purpose of obtaining general advice. They may produce to the funder and advisor copies of previously unpublished details of the target's business plans, accounts, finances and other information which will undoubtedly be classed as confidential. As soon as the director commences discussions with potential financiers or other third parties and divulges information confidential to the target company, he is likely to be in breach not only of his general fiduciary duties to the company but also of his duty of confidentiality. Therefore, any director who makes use of information confidential to the company during the course of preparation for a buy-out will be at risk unless he has first obtained the prior consent of the target company to discuss the information of the purpose of carrying out the buy-out. Also the recipients of confidential information from any such director will be at risk if they have actual or constructive knowledge that the information is confidential. In terms of the law of confidentiality, the court has long had an equitable jurisdiction to restrain third parties from using information obtained in breach of confidence.[115] Funders and advisors who use that information will be exposed to an action for damages if it can be show that its wrong doing caused the target loss. In order to avoid

discussion with another shareholder, disclosing similar information with a view to persuading that shareholder to mount a rival take-over bid. Mergarry VC decided that, in the circumstances, the company was no longer able to argue that the information was sufficiently confidential to prevent third parties, including its employees, from making use of it.

114 *Ibid.*

115 Maurice, Dwyer, *Private Equity Transactions, supra* note 58 at para. 1.38.

potentially embarrassing situation, it is advisable for them either to obtain such confidential information directly from the target or its owners, or at least ask management to confirm that Target has agreed that such information may be forwarded to them.

5. Disclosure of directors' interests is required at common law and under Section 317 of the Companies Act 1985.

Both the common law and statute contain rules requiring directors to disclose the existence and nature of any personal interest which they have in a contract to which their company is a party.

It was discussed above that the common law provides a general equitable requirement that a director may not have a personal interest in a contract with his company without the approval of the company in general meeting. Any such contract is voidable at the instance of the company and the director is liable to account for any profit he has gained from the transaction. This general rule is almost invariably relaxed by provision in the company's articles of association, for example, Regulations 85, 86 and 94 to 96 of the Companies Act 1985. Contained in UK Statutory Instruments,[116] Regulation 85 allows a director to be a party to, or otherwise interested in, any transaction or arrangement with the company, or in which the company is otherwise interested, and to be a director or other officer or employee of any body corporate promoted by the company or in which the company is interested, provided that he has disclosed to the board the nature and extent of any material interest which he has.[117]

[116] The Companies (Table A to F) Regulations 1985/805 as amended by Companies (Tables A to F) Regulations 1985/1052).
[117] The Companies (Table A to F) Regulations 1985/805 as amended by Companies (Tables A to F) Regulations

Regulation 86 provides for the director to be able to give a general notice on the board indicating his potential interest in any transaction involving a specified person or class of persons which could include Newco.[118] However, Regulations 85 and 86 should not be confused with entirely separate procedural requirements contained in Regulation 94 concerning the ability of directors to vote at meetings of the board or committees of the board on resolutions concerning matters in which they have a direct or indirect interest.[119]

The statutory requirements for disclosure of directors' interests in transactions are contained in section 317 of the companies Act 1985. A director who fails to comply with section 317 is liable to a fine.[120] It provides that it is the duty of a director of a company who is directly or indirectly interested in a contract or proposed contract with the company to declare the nature of his interest at a meeting of the directors of the company.[121] The case of *Guinness plc* v. *Saunders and Another*[122] establishes that disclosure must be to a full board meeting and not to a committee of the board. For this purpose "contract" includes any transaction or arrangement (whether or not constituting a contract) made or entered into on or after 22nd December 1980[123] including transactions or arrangements of the kind described in section 330 concerning prohibition of loans and quasi-loans to directors and connected persons.[124]

1985/1052) Regulation 85.

[118] The Companies (Table A to F) Regulations 1985/805 as amended by Companies (Tables A to F) Regulations 1985/1052) Regulation 86.

[119] The Companies (Table A to F) Regulations 1985/805 as amended by Companies (Tables A to F) Regulations 1985/1052) Regulations 94, 95, 96.

[120] The Companies Act 1985, Section 317, Subsection (7).

[121] The Companies Act 1985, Section 317, Subsection (1).

[122] See *Guinness plc* v. *Saunders and Anothe* [1988] B.C.L.C. 43.

[123] The Companies Act 1985, Section 317, Subsection (5).

[124] The Companies Act 1985, Section 317, Subsection (6).

Furthermore, in the case of a proposed contract, the declaration shall be made at the meeting of the directors at which the question of entering into the contract is first taken into consideration, or if the director was not at the date of that meeting interested in the proposed contract, at the next meeting of the directors held after he became so interested. And in a case where the director becomes interested in a contract after it is made, the declaration shall be made at the first meeting of the directors held after he becomes so interested.[125] It should be noted that, in the context of a management buyout, disclosure should be made at a very early stage. It applies to "proposed contracts" and the specific notification requirements provide for the declaration of interest to be made at the point at which the question of entering into the contract is "first taken into consideration".

This statute also provides for the requisite declaration of interest to be given by general notice. For example a general notice given to the directors of a company is deemed a sufficient declaration of interest by a director to the effect that he is a member of a specified company or firm and is to be regarded as interested in any contract which may, after the date of the notice, be made with that company or firm, or he is to be regarded as interested in any contract which may after the date of the notice he made with a specified person who is connected with him within the meaning of Section 346.[126]

Hence, as soon as the principle of a management buyout has been agreed with the target company or its shareholders, it is prudent for the directors in question to notify their

[125] The Companies Act 1985, Section 317, Subsection (2).
[126] The Companies Act 1985, Section 317, Subsection (3).

respective interests in Newco and in any transaction with the target (or concerning Target's shares) both for the purpose of Regulation 85 and Section 317.

6. Other statutory duties.

In addition to section 317, the avoidance of directors' conflicts of interest is enforced by the system of monitoring and disclosure under sections 312 to 316 of the Companies Act 1985.

Sections 312 to 314 of the Companies Act contain provisions intended to provide companies and shareholders with the right to approve or veto payments to directors for compensation for loss of office. It can be seen that Section 313 which applies on a sale of assets and Section 314 which applies on sales of shares of the target address payments made to a director by any party including the vendor or the target, whereas only payments made to a director by his own company are caught by section 312. It shall be noted that Sections 312 to 314 do not apply to bona fide payments by way of damages for breach of contract or by way of pension in respect of past services.[127]

Section 320 of the Companies Act 1985 prohibits an arrangement for the acquisition of one or more non-cash assets of the requisite value from the company by a director of that company or its holding company or a person connected with such director, unless the arrangement is first approved by a resolution of the company in general meeting or if appropriate by a resolution in general meeting of the holding company. The most relevant connection in management buy-outs is that Newco is connected with a director if the director is interested in

[127] The Companies Act 1985, Section 316, Subsection (3).

at least one fifth of the nominal value of the equity share of Newco or is entitled to exercise or control more than one fifth of the voting power at any general meeting of Newco according to Section 346.

The application of Section 320 will depend upon the relationship between the members of the buy-out team at the time of transaction. If this relationship unavoidably triggers Section 320 to apply, the requisite shareholders' approval should be obtained. In the case of a quoted company buy-out, it is probable that shareholder's consent will in any event be required by virture of Chapter 11 of the Listing Rules, which deals with transactions between related parties.

Overall, it is important either to ensure that the relevant transaction does not fall within Section 320 or to obtain the necessary shareholder's approval. If it is not obtained, the arrangement is voidable at the instance of the company.

There are additional rules and guidelines arising out of the provisions of the Listing Rules of the Financial Services Authority, the City Code on Takeovers and Mergers, and the Institutional Shareholder Committees' Guidelines. Some of these are dealt with in detail later in this Chapter.

II. Pricing and financing the MBOs

1. Valuation and price

The total finance required for a MBO will be made up of the purchase price, transaction cost, any funding required for capital expenditure or working capital and any bank debt taken over.

To overpay for the business is the cardinal sin of management buy-outs. To do so dramatically increases the risk in the investment, as it becomes possible for a business to perform reasonably well and yet still fail to achieve a return for the investors and particularly managers when they wish to sell. Therefore, valuing the target and assessing an appropriate price is very important.

Valuing any company will always involve an element of judgment in arriving at the bid price. Broadly there are three methods employed:[128]

A. Earnings based valuation

Earnings based valuations are one of the most commonly used measures of value in financial circles. These valuations express value in terms of a multiple of profits, and this method can be broken into transaction multiples and public company comparable multiples.

Transaction multiples relate to researching transactions in the target sector over several years in order to determine an average multiple. The post tax multiple relates to the price earnings

[128] Debbie Anthony, *supra* note 11 at 19.

ratio, although this will be at a discount to public company multiples to reflect non-liquidity status.

Price earning ratios are defined as price divided by earnings after tax and after preference dividends. The calculation can be performed for a company as a whole or for each share in the company. Financiers tend to refer to the price for a company in the context of its most recent post tax profits. For example if a company that generated post tax profits of £1m was sold for £9m, this transaction would have been at a price earning of 9.

For any company quoted on the Stock Exchange, each company has a price earnings ratio which determines the market capitalization of that company at a particular time; this figure can be easily calculated and is published daily in the Financial Times.[129] For unquoted companies there is no regular pricing mechanism and therefore no recorded price earnings ratio, but this principle can also be applied. Thus one can study quoted share prices for the particular market sector containing the target company and obtain the current multiples. A quoted market price earning ratio will probably need adjusting downwards for an unquoted private company due to the lack of marketability of shares in a private company.

Overall, the price earnings ratios paid in recent transactions and price earning ratios at which comparable quoted business are being traded are often used as an appropriate guide in the valuation exercise.

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129 Glossary- PE ratios, online: The Center for Management Buy-out research <http://www.cmbor.org/>.

B. Net asset valuation

Usually, both the price earnings ratios and net asset valuation are used to determine valuations in management buy-outs. Vendors are unlikely to accept less than net asset value, because it is this price which fits comfortably from both a psychological and an accounting viewpoint, as, at that price, the vendors realize the assets earned by the business to the date of sale and no accounting loss is recorded.

This assets valuation model is based on a company being worth the value of its net assets as shown in the balance sheet. However, it can be argued that the value of the target is simply the valuation of the assets less any liabilities that it has in its balance sheet. It cannot provide a simple guide to the price that should be paid for several reasons. First, the balance sheet is usually months out of date. Second, the market value of an asset may be materially different from the value shown in the balance sheet. Finally, for certain businesses the value of the assets is no guide to the cash generating ability of the business. Nevertheless, the net asset value of the company can be used for setting a base price level.

C. Discounted cash flows(DCF)

The principle of discounted cash flow is that the value of any asset is the present value of the future cash flows it will generate. This method uses the cash flow projections of the business and the cost of capital raised to finance the deal to value the business.

2. Types and sources of finance

A distinguishing characteristic of all management buy-outs is that the finance raised for the acquisition is based on the financial condition of the company being bought, rather than on the acquiring company, which is a usually simply a shell company with no business or assets of its own. This feature distinguishes management buy-outs from a normal corporate acquisition, in which the acquiring compay is a business in its own right, and is capable of borrowing funds or raising capital wholly or partly on the basis of its own financial state to make the acquisition. A management buy-out will usually involve the establishment of a Newco, which will be funded by both debt and equity and which will apply the funds at its disposal in the acquisition of a target company or business.

Broadly, the bulk of the funding will come from financial institutions in the form of equity and debt. Debt is usually provided by specialized acquisition finance units of UK clearing banks or investment banks, while equity is provided by venture capital or private equity houses.

Virtually all MBOs are financed with a combination of senior debt, subordinated debt and equity, other sources such as mezzanine and vendor finance may also be used. The amount of equity required in a transaction is determined in part by the amount of debt that can be borrowed. And finance for a management buy-out is conventionally provided in three or more layers. In terms of seniority, senior debt, subordinated debt and equity are in rank order.[130]

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[130] Lord Hanson, *supra* note 17 at para. 14.22.

The following describes the various components of financing in a typical MBO.

A. Debt Finance

Debt may include bank loans, overdrafts, and lease finance and may be long or short term, secured or unsecured. Unlike the equity holder who is a member of the company the provider of debt finance is a creditor of the business. The provider of debt finance will normally take security to protect his lending. There are two categories of debt finance the providers of which have slightly different objectives.

i. Senior Debt

The first category is known as senior debt. Senior debt is he highest form of debt and will rank for repayment ahead of other types of finance. Consequently it is the most secure form of debt. Providers of senior debt will require security over the company's tangible and intangible assets and even, perhaps pledges of share capital of subsidiaries. Especially for large transactions, senior debt can effectively be secured on the cash flow of the business.

Typically, 50% to 70% of an MBO's financing takes the form of senior debt. A senior loan is collateralized by a first lien on the current and long-term assets of the company. Senior financing is generally made available from banks, although privately placed notes to institutional investors are also possible, or a public issue of bonds is on occasion the source of senior debt.

One component of senior debt is a senior term loan. This is a loan based on a certain percentage of the appraised fair market value of the land and buildings and the orderly liquidation value of the machinery and equipment. Such loans are further limited by the predictability of cash flow to service senior debt. The term for senior term debt is typically five to eight years.

Another component of senior debt is a revolving line of credit, which is available at the option of the borrower for a defined period, usually one year with renewal provisions. It is loaned to an MBO based on a certain percentage of the appraised orderly liquidation value of the eligible accounts receivables and inventory. Such loans are further limited by the predictability of cash flow to service senior debt.[131]

ii. Subordinated Debt

The second is known as subordinated debt. This type of debt may or may not be secured but will effectively rank behind senior debt in terms of repayment and interest payment priority. As a result, subordinate debt will carry a higher rate of return for a lender to compensate for the additional risk. For the lender of subordinate debt, profits and cash flows have to be sufficient to service borrowings. Sometime, mezzanine finance which will be discussed later takes the form of subordinate debt.

Typically, 15% to 30% of the financing of an MBO is in the form of subordinated financing. These funds are subordinated to senior debt and generally have only second claim to the collateral of the company. Subordinated financing is generally made available directly from

[131] Debbie Anthony, *supra* note 11 at 27-28.

subordinated debt private and public funds and, in large transactions, directly from insurance companies. Alternatively, it is raised through public offerings of high-yield ("junk") bonds to insurance companies, pension funds and other institutional investors. In many MBOs, subordinated debt is given back to the seller, comprising a portion of the purchase price.

The term of such financing is typically six to 10 years, and principal payments are commonly deferred until after the senior debt is retired. These funds are loaned based on the amount and predictability of cash flow exceeding that required to service senior debt. Interest costs can be anywhere from 2 to 8 percentage points more than senior debt. Because subordinated debt usually has little collateral protection, it almost always is granted an equity kicker[132] with the intention of providing the lender with an 18% to 27% compound annual total return over five years resulting from both the interest charges and equity kicker. The required return varies based on the risks associated with the transaction, the company, its market and its industry.

So far as the debt element is concerned, in management buy-out this will be provided pursuant to a term loan agreement or facility between the bank and the Newco containing the usual terms including, in particular, positive covenants (matters which the company must do unless the bank consents), negative pledges (matters which the company may not do except with the consent of the bank) and events of default (which can trigger immediate repayment of the debt). The term loan agreement will also contain detailed financial covenants that must be adhered to.

[132] Options or warrants to subscribe for equity at a later date.

B. Equity finance

i. Equity

Equity is essentially the term used to describe shares in a business conveying ownership of that business. It is normally permanent and it is the highest risk finance. The equity shareholder has a right to income after all other providers of finance have taken their return, and a right to whatever assets of the business remain after other providers of finance have been repaid.[133]

Typically, 10% to 20% of the financing of an MBO is in the form of equity financing. These funds make up the difference in the financing requirement and the financing available in the form of debt. The most common source of equity finance for buy-outs is the venture capital market.

Since equity finance carries the greatest risk and the greatest potential return, the management, in an MBO, usually invests in the equity of an MBO company together with a corporate investor or a group composed of institutional equity investors. The seller and subordinated lenders sometimes receive equity in the new company. An institutional investor investing in the equity of an MBO typically seeks a 30% to 40% compounded annual total return over five years, depending on the perceived risk. These returns are only projections; the investor has no contractual rights to such returns like a lender has concerning interest charges.

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[133] Debbie Anthony, *supra* note 11 at 26.

On the equity side, a typical equity structure might consist of ordinary shares, preferred ordinary shares or preference shares. The ordinary shares will be held by the management and possibly also by the venture capitalist, the preferred ordinary shares and the preference shares will be held by the venture capitalist. The ordinary share is the pure form of equity finance. It ranks for dividend and repayment of capital behind every other type of finance. However, if the business is successful, there is the potential for ordinary shareholders to make the largest gains. Preference shares normally carry a fixed dividend, the preference shareholders rank behind providers of debt and creditors but ahead of the ordinary shareholders in terms of dividend and repayment of capital. The preferred ordinary shares is preferred to ordinary shares in the event of a winding up and participates in that it receives a dividend.[134]

ii. Equity ratchet

The rights and obligations of these different classes will vary according to the financial requirements of the venture capitalist. This will be the case particularly if there is to be an equity ratchet. An equity ratchet arrangement is designed to result in the percentage of the Newco's equity represented by the management's shares varying according to the performance of the buy-out vehicle after the investment is made. This is often introduced into pricing negotiations between the management and venture capitalists to bridge the gap between the management's optimistic performance forecasts and venture capitalists' more conservative projections. Venture capitalist will not allow the ratchet mechanism to limit totally their upside potential if the buy-out performs better than they expect but they will

[134] *Ibid.* at 26.

share the upside with the management team.[135]

Ratchet mechanisms can take various forms and depend on the financing structure. Convertible redeemable preference share is quite common. These shares are held by the venture capitalists and all or part are redeemed if projections are achieved or partially achieved but converted into ordinary shares if results fall short of projections thus diluting management's holding in the ordinary shares.

Whilst common in the management buy-outs in 1980's, ratchets are less common in today's market place with many institutions arguing strongly that negotiations at the outset should conclude the level of the management's shareholding.[136]

C. Mezzanine Finance

Of the three finance layers described above, a new financing phenomenon called mezzanine finance, which started to be used in 1985, is the most novel in historical terms and is most closely identified with the subject of "leverage". This type of finance referred to variously as mezzanine debt, subordinated debt, mezzanine capital or simply mezzanine is the layer of capital that falls in between senior debt and equity. It is often used to bridge the gap between the secured debt a business can support, the available equity and the purchase price. Because

[135] For example, a company currently generating net profits of £1m is subject to an MBO. The management project it will generate net profits of £3m in three years' time, but the investor believes it is likely to generate net profits of £2m in three years' time. The investor requires 30% of the equity to achieve his required return based on net profits £2m at the end of three years. If he believed the company would make £3m net profits he would only require 20% of the equity. A ratchet is agreed that provides that in year 3 for every £100,000 net profit in excess of £2m and up to £3m, management will receive an extra 0.5% of the equity. Accordingly if they meet their target of £3m they will end up owning 75% of the company. In this example there is an upside limit to management's share of the company.

[136] Debbie Anthony, *supra* note 11 at 50-52.

of this, and because it normally ranks behind senior debt in priority of repayment, unsecured mezzanine debt commands a significantly higher rate of return than senior debt. Mezzanine finance has some of the features of both debt and equity. It is generally provided by way of a high interest term loan, or a debt with a lower rate of interest but may be associated with options or warrants to subscribe for equity at a later date (often known as an equity kicker). Whereas senior debt will generally be provided from conventional banks sources, mezzanine finance is often made available by venture capital institutions and other specialists in the buy-out field including pension funds, insurance companies and other institutional investors. Also, commercial and investment banks have also become active players in the mezzanine market. Through some banks choose to be in one and only one layer of finance, other banks will seek positions in both senior and mezzanine layers, looking to enhance an overall return by accepting he high risk of mezzanine.[137]

The amount of mezzanine finance available to a buy-out team will depend on factors similar to the debt and equity. However, the debt provider may feel the characteristics of the mezzanine are too close to debt, this will be the case if the mezzanine finance carries an interest rate as high as or higher than the debt rate as it will cause a drain on the resources of the business and jeopardize the debt provider’s position even through the mezzanine may be legally subordinated to the senior debt. Alternatively the debt provider may require additional financial covenants to protect his position.

D. Vendor Finance

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[137] *Corporate Finance: Leveraged and Management Buy-outs,* second ed. (London: Euromoney Publications, 1994) at 14.

Vendor finance can be either in the form of deferred loans from, or shares subscribed by, the vendor. The vendor may well take shares alongside the management in the new entity. This category of finance is generally used where the vendor's expectation of the value of the business is higher than that of management and the institutions backing them.[138]

III. MBOs concerning public companies

A management buy-out by or from a publicly listed company raises a number of issues in addition to those common to other general management buy-outs. The provisions of the City Code on Takeovers and Mergers ("City Code"), the guidelines published by the Institutional Shareholders' Committee and the Listing rules of the London Stock Exchange will apply to the management buy-out transactions as well as the common law rules and statutory provisions.[139] Other parts of this thesis are relevant to management buy-outs; this part summarises the special features of management buy-outs of listed public companies as well as unlisted public companies to the extent the City Code applies to such companies.

1. MBOs under the City Code on Takeovers and Mergers

In UK, all public companies and certain private companies are subject to the provisions of the City Code.[140] If the target company in a management buy-out is a public company, its conduct and that of Newco and their respective managements will be subject to the City Code.[141]

A. Introduction of the City Code

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138 Debbie Anthony, *supra* note 11 at 53.
139 *Ibid*. at 98.
140 Maurice Dwyer, *Management buyouts* (London:Sweet & Maxwell, 1997) at para. 14.01.
141 Debbie Anthony, *supra* note 11 at 77. Also see the Disclosure Table(26/5/2004) of the Takeover Panel which shows there are some proposed management buy-outs of listed company currently. Online: The Takeover Panel <http://www.thetakeoverpanel.org.uk/default.htm>.

The most distinctive feature of UK takeover regulation is the dominant role of self-regulatory institutions, particularly the Panel on Takeovers and Mergers which issues and supervises the City Code on Takeovers and Mergers.[142] In UK, although the direct regulation of takeovers under the Companies Act 1985 and the common law is quite limited, the principal rules, procedures, and practices are prescribed by the City code and administered by the Takeover Panel in a highly efficient and flexible manner.[143]

The City Code does not have the force of law, but a number of sanctions can be exercised.[144] If a material breach of the City Code occurs, the relevant person may be invited to appear before the Panel for a hearing. Compliance with Panel rulings is ensured in a number of ways.[145] Also, the City Code has been endorsed by the DTI and by the London Stock Exchange and other regulatory bodies.[146] Those who do not comply with high business standards and act according to the City Code may find that, by way of sanction, the facilities of the UK securities market are withheld.[147] Therefore, the Panel remains non-statutory but it is clearly linked to the regulatory structure established by the Financial Services and Markets

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142 Stephen Kenyon-Slade, *Mergers and Takeovers in the US and UK: Law and Practice* (New York: University of Oxford Express, 2004) at para. 7.01.

143 *Ibid* at para. 7.02.

144 City Code, Introduciton, para, 1(c).

145 The City Code, online: The Takeover Panel <http://www.thetakeoverpanel.org.uk/default.htm>. ("In essence, it derives from the fact that the organisations represented on the Panel feel bound by the Code and together comprise the totality of interests that constitute the domestic securities markets in the United Kingdom. In addition:
Companies and their advisers know that the Panel can and will issue critical public statements during the course of a takeover bid if necessary. Shareholders are likely to treat warily documents which have been publicly criticised by the Panel.
In particular, the Code has been endorsed by the Financial Services Authority ("FSA") under the Financial Services and Markets Act 2000 (the "FSMA"). The effect of endorsement of the Code is that the FSA may, at the request of the Panel, take enforcement action against a person authorised under the FSMA who contravenes the Code or a Panel ruling. Such action can include public censure, fines, the removal of authorisation, the imposition of injunctions and orders for restitution. In addition, the FSA may, again at the request of the Panel, take enforcement action against an individual who is an "approved person" (eg. a director of an authorised firm).
All those who deal in the securities markets are at risk, in the event of breach of Panel rulings, of being considered no longer "fit and proper" to be authorised under the Act to carry on investment business.")

146 *Ibid.*

147 City Code, Introduction, para, 1(c).

Act 2000.[148]

The City Code applies to offers for all listed and unlisted public companies considered to be resident in UK, the Channel Island, or the Isle of Man.[149] The City Code will also govern takeover offers for private companies considered to be resident but only when some requirements are satisfied.[150]

It has been recognized for some time that a management buy-out of a public company gives rise to particular concerns relating to conflicts of interest and the potential for management insiders to manipulate affairs to their advantage and to the detriment of shareholders.[151] In October 1990, the panel introduced a number of amendments to the City Code to take account of the special circumstances surrounding MBOs of listed public companies[152]. These are discussed in more detail below.

B. Specific applications of the City Code to MBO offers.

i. Independent advice (Rule 3, Appendix 3)

The City Code emphasizes that the need for competent advice by independent advisers is of paramount importance in takeover transactions.[153] It expressly requires the board of directors

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148 Takeover Panel, Annual Report on the Year ended 31 March 2003. ("It is the Panel's practice to focus on the specific consequences for shareholders of rule breaches. Accordingly, the Panel's immediate priority is to provide appropriate redress; thereafter it will consider whether disciplinary action, if any, is necessary. If the Panel finds there has been a breach, it may have recourse to private reprimand, to public censure, to reporting the offender's conduct to another regulatory authority (for example, the Department of Trade and Industry or the Financial Services Authority) and to requiring further action to be taken, as it thinks fit.")

149 City Code, Introduction, paras. 4 (a), 4 (b).

150 City Code, Introduction, para, 4 (a).

151 Maurice, Dwyer, *Private Equity Transactions*, *supra* note 58 at para. 15.04.

152 Weinberg & Blank, *supra* note 5 at para. 2-6010.

153 Stephen Kenyon-Slade, *supra* note 142 at para. 9.31.

of the target company to obtain competent independent financial advice on any offer.[154]

In an MBO transaction, the requirement to obtain competent independent advice and make the gist of such advice available to the shareholders reduces the likelihood that directors will act in their own interests and not in the best interests of the target company, or that directors will otherwise breach their fiduciary duties.[155] Thus, the crucial role played by an independent adviser as a policeman is indicated in the City Code's provision that the requirement for competent independent advice is of great importance in management buy-out transactions and other going private transactions made by the existing controlling shareholders.[156]

The City Code further states that, in the context of an MBO, it is particularly important that the independence of the financial adviser is beyond question and the adviser should be appointed as soon as possible after the board becomes aware that an offer may be made.[157] Where the existing financial adviser of he target company has had an especially close relationship with any member of the MBO team, a new financial adviser shall be appointed to advise on the merits of the offer.[158]

The responsibility of the financial adviser is therefore shared with the company's independent directors. As Rule 3.2 provides that the board of an offeror must obtain competent independent advice on any offer when the directors are faced with a conflict of interest. The

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[154] City Code, Rule 3.1.
[155] Stephen Kenyon-Slade, *supra* note 142 at para. 9.34.
[156] City Code, Rule 3.1, Note 1.
[157] City Code, Rule 3.1, Note 1.
[158] Spencer Summerfield & Chiris Hale, "From Public to Private: Management Buyouts of Listed Companies" (1998) PLC 9(4), 1, 1998, 33-39.

substance of such advice must be made known to its shareholders.[159]

In most management buy-outs cases, the independent directors of the target company shall retain target company's existing advisers as their adviser under Rule 3, leaving Newco to choose a separate adviser of its own, because the City Code states that the Panel will not regard as an appropriate person to give independent advice a person who is in the same group as the financial or other professional adviser to an offeror or who has a significant interest or financial connection with either the offeror or the target company of such a kind to create a conflict of interest.[160] It is also required that the target company's adviser should have a sufficient degree of independence from the offeror to ensure that the advice given is properly objective; accordingly, it may not appropriate for a person who has had a recent advisory relationship with an offeror to give advice to the target company.[161] Note 3 to Rule 3.3 draws attention to the fact that certain fee arrangements between an advisor and an offeree company may create a conflict of interest which would compromise the adviser's independence, especially a fee that is paid to the adviser of a target company only in the event the offer fails.[162]

Section 2 of Appendix 3 to the City Code, which deals with financial advisers and conflicts of interests, set forth instances where a conflict of interest may arise between the financial adviser and the company it represents, or where the financial adviser's independence is

[159] City Code, Rule 3.2.
[160] City Code, Rule 3.3.
[161] City Code, Rule 3.3, Note 1.
[162] City Code, Rule 3.3, Note 3.

potentially compromised.[163] Such conflict may arise where the adviser previously represented one of the parties in the transaction and in possession of material confidential information relating to that representation, and currently represents the other party.[164] In such a case, the adviser may be compelled to withdraw to avoid likely conflict.[165]

ii. The response of the target company's board of directors and independent committee of directors. (Rule 25.1, note 3 and note 4)

Rule 25.1 of the City Code supplements Rule 3.1 by providing that the target's board must circulate its views on the offer, including any alternative offers, and must make known to its shareholders the substance of the advice given to it by the independent advisers appointed pursuant to Rule 3.1.[166]

However, there is an inherent conflict of interest in any proposed MBO where some or all of the directors of the bidding vehicle are also directors of the target company. On the one hand, the bidder will wish to pay as little as possible for the target company while still obtaining the recommendation of the target company's board to accept the offer. On the other hand, the target company's board will wish to try to sell at the best price.[167]

Therefore, the City Code severely provides defensive measures. If the offer involves a management buy-out, a director will normally be regarded as having a conflict of interest where it is intended that he should have a continuing role (whether in an executive or

[163] City Code, Appendix 3, Section 2.
[164] City Code, Appendix 3, Section 2.
[165] City Code, Appendix 3, Section 2.
[166] City Code, Rule 25.1.
[167] Spencer Summerfield, *supra* note 158.

non-executive capacity) in either Newco or the target if the offer is successful.[168] In such circumstances, that director should not join with the remainder of the board in the expression of its views on the offer.[169] Furthermore, the nature of the conflict of interest of a director must be clearly explained to shareholders.[170] But it should be noted that this does not relieve the director from responsibility for the remainder of the information supplied to shareholders.[171]

Due to the inherent conflict, it is crucial in any contemplated MBO transaction for the target's board to establish an independent committee of directors who will play a role to scrutinize the proposals to be made by the MBO team and to advise target shareholders on whether or not to accept the MBO team's offer.[172] The committee should comprise only those directors of the target company who are unconnected with, and independent of the MBO team. In order to be regarded as independent, no member of the committee should have a continuing role (whether in an executive or non-executive capacity) in either the bidder or the target company in the event of the offer being successful.[173] The independent committee will initially need to decide whether, in principle, it is in the interests of shareholders of the target company to permit the MBO team to formulate an offer to be put to shareholders.[174] It is also important that the buy-out team resist the temptation to make any kind of offer to the members of the independent committee which would impugn their independence.[175]

168 City Code, Rule 25.1, Note 4.
169 City Code, Rule 25.1, Note 3.
170 City Code, Rule 25.1, Note 3.
171 The buy-out team's duty as directors will be discussed subsequently.
172 Stephen Kenyon-Slade, *supra* note 142 at para. 10.50.
173 City Code, Rule 25.1, Note 4.
174 Spencer Summerfield, *supra* note 158.
175 Graham Stedman, *Takeovers* (London: Longman Law, Tax and Fianance Longman Group UK ltd, 1993) at para.

iii. Equality of information to shareholders and competing bidders (Rule 20.2 and 20.3)

It is likely that any equity or debt provider for an MBO requires legal and financial due diligence to be carried out on the target company.[176]

Rule 20.2 of the City Code poses a particular problem if the management team's offer attracts a competing offer.[177] Under this rule, any information given to an offeror or potential offeror must, on request, be given equally and promptly to another offeror or bona fide potential offeror even the other offeror is less welcome.[178] Apparently, in the case of an MBO, the management team may have full access to most, if not all, of the target company's confidential information in their capacity as directors or senior managers of the target company. However, where a target company provides confidential business information or price sensitive material to the management team, the target company is obliged to disclose the same information to any other less welcome or hostile offeror or potential offeror which may subsequently emerge.[179] Therefore, the management team will find itself in the problematic position where, on the one hand, it is desirable and necessary to furnish Newco and its funders with a complete package of information and, on the other hand, that information will thereby become available to a competitor.

A note to the City Code 20.2 prescribes the information which must be passed to competing offerors in the case of management buy-out offers is only the information which is generated

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[176] Stephen Kenyon-Slade, *supra* note 142 at paras. 9.131-9.133.

[177] Debbie Anthony, *supra* note 11 at 101.

[178] City Code, Rule 20.2.

[179] Stephen Kenyon-Slade, *supra* note 142 at para. 9.131.

by the target company (including the management of the target company acting in their capacity as such) and which is passed to external providers or potential providers of finance (whether equity or debt) to the offer or potential offer.[180]

It should be noted that Note 3 refers only to information generated by the target company (including the management of the target company acting in their capacity as such).[181] The note is ambiguous, since the test of whether information has been generated by the management in his capacity as a member of the buy-out team or as a director of the target company remains subjective. Management may therefore be able to circumvent this requirement by arranging for predictions and other key financial information to be produced by the funders based on the information furnished by management, rather than to be produced directly by management themselves.[182] However, management should bear in mind that the Panel will block actions which it deems breach the spirit of the Code, notwithstanding that the action may comply technically with the rules of the City Code.[183] It may therefore be prudent to consult with the Panel when considering what information should be disclosed, otherwise it may take a risk of subsequent censure. Also, it is left up to the independent directors and their advisers to determine and ensure fair dealing.[184]

Note 3 on Rule 20.3 continues to state the Panel's expectation that the directors of a target

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180 City Code, Rule 20.2, Note 3.
181 *Ibid*.
182 Maurice Dwyer, *Management buyouts, supra* note 140 at para. 14.05.
183 See the Takeover Panel, Annual Report on the Year Ended 31 March 2003. ("The essential characteristics of the Panel system are flexibility, certainty and speed, enabling parties to know where they stand under the Code in a timely fashion. These characteristics are important in order to avoid over-rigid rules and the risk of takeovers becoming delayed by litigation of a tactical nature, which may frustrate the ability of shareholders to decide the outcome of an offer.")
184 Weinberg & Blank, *supra* note 5 at para. 2-6015. See also the discussion of City Code, Rule 20.3 below.

company who are involved in a management buy-out offer shall co-operate with the independent directors of the target company and its advisers to collect the information which is provided to the management team's debt and equity providers.[185]

The City Code also provides that, if the offer is a management buy-out the offeror must on request promptly provide the independent directors of the target or its advisers with all information which has been furnished by the offeror to external providers or potential providers of finance (whether equity or debt) for the management buy-out.[186] This rule is clearly designed to ensure that the independent directors and their financial adviser have the same information as the providers of finance for the offer when evaluating the merits of the offer relative to the value of the target company.[187] It shall be noted that the information required to be disclosed under Rule 20.3 also includes information on the offeree company developed by or with the assistance of management for the purpose of the transaction. For instance, a business model prepared by a private equity investor will normally include the management team's opinions, estimates and projections based on the team's knowledge of the offeree company, and usually shall be disclosed in its entirety. Similarly, due diligence reports by lawyers, accountants and property consultants should be disclosed under Rule 20.3, as they will be derived from information supplied by the offeree company, reviewed by the management team for accuracy and furnished to the financiers.[188]

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[185] City Code, Rule 20.2, Note 3.
[186] City Code, Rule 20.3.
[187] See the Takeover Panel, Annual Report for the Year Ended March 2002.
[188] The Takeover Panel, Annual Report for the Year Ended March 2002. ("The information passable pursuant to Rule 20.3 includes not only information generated by the offeree company but also information on the offeree company developed by or with the assistance of management for the purpose of the transaction. A business model, for instance, prepared by the private equity house will normally include the management team's opinions, estimates and projections based on the team's knowledge of the offeree company, its business and the markets in

A very important distinction shall be drawn between Rules 20.2 (information to competing bidders) and 20.3 (information to independent directors). Information generated by the management of the target company acting in their capacity as members of the management buy-out team is not required under Rule 20.2 to be provided to competing bidders. In contrast, pursuant to Rule 20.3, all relevant information supplied to external debt or equity providers prepared by the management in their capacity as members of the management buy-out team shall be provided to the independent directors.[189]

iv. The prohibition of special arrangements with favorable conditions. (Rule 16)

Under the City Code, all shareholders of the same class of a target company must be treated similarly by Newco.[190] As such, Rule 16 of the City Code provides a broad prohibition on arrangements involving favourable conditions that may result in the unequal treatment of shareholders of the target company. It shall be noted that Rule 16 will also be of particular relevance in management buy-out transactions, as in this situation, a venture capitalist investing in the equity of Newco and the members of the management team will be treated by the Panel as acting in concert with Newco.[191] This rule states that, unless the Panel otherwise

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which it operates and will accordingly be disclosable in its entirety. Similarly, due diligence reports prepared by professional advisers (e.g. accountans, lawyers and property consultants) are likely to be disclosable under Rule 20.3, since they will be derived from information supplied by the offeree company, reviewed by the management team for accuracy and shown to the financiers.")

189 Spencer Summerfield, *supra* note 158.

190 City Code, General Principle 1.

191 The Takeover Panel, Annual Report on the Year Ended March 1998. ("MBOs AND SIMILAR TRANSACTIONS- During the course of the year, the Executive has noted a significant increase in the number of offers for Code companies by way of management buy-outs, management buy-ins, institutional buy-outs and other similar transactions. As a result, the Executive has reviewed how the Code should be applied to such transactions and some of the main issues are highlighted below.
By definition, such transactions often involve incumbent management of the offeree taking an equity stake in the offeror bidding vehicle. If these individuals are also shareholders of the offeree, the Executive will want to ensure that such arrangements do not offend against the principle that all shareholders be treated similarly. The Executive will normally require the offeree's adviser to state in the offer document that the terms of management's participation in the offeror are fair and reasonable so far as other offeree shareholders are concerned. Independent

consents, Newco and any person acting in concert with the bidder may not make any arrangements with shareholders or deal or enter into arrangements to deal in shares of the target company or enter into arrangements which are not being extended to all shareholders.[192]

In certain management buy-out transactions, venture capitalists will normally want the members of the management team to take the equity interest in Newco so that they share the risk and are properly motivated in running the new group following the transaction.[193] On the other side, management will also be keen to have a share of the equity so that they may participate in future gains of the capital value of the enlarged group.[194] However, the equity backers of Newco will not wish to extend the offer of participation in the shares of Newco to all of Target's shareholders.[195] Where the management are shareholders, this may mean that they are offered a deal which is different from that being offered to other shareholders.[196] If this is the case, they will be a breach of the Rule 16. However, the Panel maybe prepared to consent to such an arrangement, if it complies with following requirement pursuant to Note 4

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shareholder approval may also be required in certain circumstances.
The Executive should be consulted at an early stage so that joint offerors (or members of the offeror concert party) are identified to ensure that, inter alia, appropriate disclosure on these parties is made in the offer document (for example, with regard to financial information on the offeror, material contracts, shareholdings and dealings). This is also important as dealings by such persons may have significant Code consequences, for example in relation to the minimum consideration which must be offered. Furthermore, in addition to the directors of the bidding vehicle, responsibility statements will be required from appropriate individuals from the joint offerors.
Where outside finance is to be raised by the offeror bidding vehicle, the Executive should be consulted if negotiations or discussions are to be extended to include more than a very restricted number of people. The Executive should also be consulted in situations where the finance for the offeror is to be provided, wholly or in part, by an entity within the same group as the proposed financial adviser to the offeree as, inter alia, this may create a conflict of interest for the latter.")

192 City Code, Rule 16.

193 Spencer Summerfield, *supra* note 158.

194 Maurice Dwyer, *Private Equity Transactions*, *supra* note 58 at para. 15.12.

195 Spencer Summerfield, *supra* note 158.

196 The Panel commented in detail on Rule 16 note 4 in its Annual Report on the Year Ended March 2000. ("Note 4 on Rule 16 recognises that in certain offers, for example MBOs, the services of certain of the offeree management need to be retained, but that management may need to be given an incentive to remain and perform in the form of a continuing financial involvement (usually including some form of equity participation) in the company. Where the management are shareholders, this may mean that they are offered a deal which is different from that being offered to other shareholders. Note 4 sets out the parameters which can make the difference acceptable, by balancing any benefits of the management's retained interest with appropriate risks.")

of Rule 16.[197]

As a condition to consenting to any special arrangements, the Panel has, as a general rule, required the financial advisers under Rule 3 of the target company to confirm in the offer document that they consider the arrangements to be fair and reasonable in the context of the offer so far as other target shareholders are concerned.[198] Accordingly, in a management buy-out, the Rule 3 adviser is required to provide two distinct views on the merits of Newco's offer, a comment upon the question whether the terms of the offer are fair and reasonable, and the other one to tell whether the arrangements with management are fair and reasonable, in the context of the offer so far as the target's shareholders are concerned.[199]

Furthermore, the Panel was previously amenable to the management team receiving different arrangements from the remaining shareholders provided that the value attributed to each of their shares in the target company is no higher than that attributed to the shares of the other target shareholders.[200] However, recent changes to the City Code states, where the offeror and the management together own more than 5% of the offeree company's equity shares, the Panel can also require the special arrangements to be approved at a general meeting of the target's shareholders, at which only the independent shareholders can vote and at which a poll

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197 The Takeover Panel, Annual Report on the Year Ended March 2000. ("The Executive was asked by the Panel to consider whether all arrangements coming within Note 4 should, as a condition of any Panel consent to such arrangements, normally be subject to approval by independent shareholders (in addition to the normal requirement of a fair and reasonable opinion from the Rule 3 adviser). Following a review, including a consultation exercise with practitioners and Panel members, the Panel decided that, in applying Note 4, a vote of independent shareholders should normally be required if the participating management and the offeror together hold more than 5% of the offeree.")

198 City Code, Rule 16, Note 4.

199 Maurice Dwyer, *Private Equity Transactions*, *supra* note 58 at para. 15.12.

200 *Ibid*.

must be taken.[201] So the Panel will normally require Newco to pursue shareholder's approval in a general meeting to the equity participation and other arrangements being offered to the management team and, in those circumstances, the management team shall not themselves vote at the meeting.[202]

Moreover, the Panel is concerned to ensure that the members of the management buy-out team take the risks as well as the rewards associated with their new shareholding in Newco.[203] For example, the Panel will not normally find acceptable an option arrangement which guarantees the original offer price.[204] As such, the Panel is unlikely to accept such provisions in management team's new service agreements or in the Articles of Association for Newco which guarantee the management team's right to subscribe for equity shares in Newco at a modest fixed price in the future, or there are provisions which entitle the management team to require Newco to purchase their shares back at a fixed price in the future.[205]

The problems caused by Rule 16 are avoided if no members of the MBO teams own any shares in the target company. However, even if Rule 16 does not apply, particulars of any special arrangements or understanding (including any compensation arrangement) existing between the offeror or any person acting in concert with it and any member of the MBO team who is also a director of the target company may need to be disclosed.[206] For example, the offer document must contain the full summary of the proposed special arrangements for the

201 City Code, Rule 16, Note 4.
202 Maurice Dwyer, *Private Equity Transactions*, *supra* note 58 at para. 15.12.
203 City Code, Rule 16, Note 4.
204 City Code, Rule 16, Note 4.
205 Maurice Dwyer, *Private Equity Transactions*, *supra* note 58 at para. 15.12.
206 City Code, Rule 24.5.

management team, including details of terms for their investments in Newco and a summary of any new service contracts for them.[207] As such, attention should be paid to the provisions of Sections 312,314 and 315 of Companies Act 1985 regarding the disclosure of, and possible requirement for prior shareholder approval of, payments made to the management team by Newco in consideration for their resignation as directors of the target company.[208] It would not be possible for target itself to fund such termination payments, since such payments would contravene the prohibition on financial assistance pursuant to Section 151 of the Companies Act 1985.[209]

v. The buy-out team's duties as directors. (Rule 19, Appendix 3)

If a director of the target company is also part of the MBO team, he does not necessarily have to resign from the target's board, but other than a fiduciary duty to continue to act in the best interests of the target company not those of Newco, he should have regard to the following:

Any information obtained by him in his capacity as such should be disclosed to the independent directors.[210] For instance, approaches from potential competing offerors or information pertinent to the offer would be caught by this requirement.[211]

As I mentioned above, the appointment of a committee of independent directors does not relieve the buy-out directors of their fiduciary duties or their duties to the target under the City

207 Maurice Dwyer, *Private Equity Transactions*, *supra* note 58 at para. 15.12.
208 See Chapter 4 I Director's duties at Common Law and other statute rules, above, for more discussion on this topic.
209 See Chapter 4 IV Financial Assistance and MBO under Section 151 of the Companies Act 1985, below, for more discussion on this topic.
210 City Code, Rule 19.2, Note 1. See also City Code, Rule 20.3 discussed above.
211 Graham Stedman, *supra* note 175 at para. 21.4.

Code.[212] In particular, they still owe their duties to presume responsibility for documents issued to shareholders of the target and to ensure the accuracy of such documents.[213]

Where a director has a conflict of interest, he should not normally join the remainder of the board in expressing its views on the offer.[214] The nature of the conflict should be clearly explained to shareholders.[215] Even though the actual recommendation to the target shareholders whether or not to accept the offer will come only from the independent committee of the target board, the other directors will still have to take responsibility for the other information contained in any circular or advertisement issued by the target company in connection with the offer.[216] Depending on the circumstances, such a director may have to make the responsibility statement required by Rule 19.2, appropriately amended to make it clear he does not accept responsibility for the views of the board on the offer.[217]

The code also states that where the offeror is controlled, directly or indirectly, by another person or group, other persons (for example, directors of the ultimate parent company) will also usually need to give a responsibility statement.[218]

The guidance note on directors' responsibilities and conflicts of interest is set out in Appendix 3 to the Code.[219]

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[212] City Code, Rule 19.2.
[213] Graham Stedman, *supra* note 175 at para. 21.4.
[214] City Code, Rule 25.1, Note 3.
[215] City Code, Rule 25.1, Note 3.
[216] City Code, Rule 19.2.
[217] City Code, Rule 25.1, Note 3.
[218] City Code, Rule 19.2, Note 6.
[219] City Code, Appendix 3, Section 1.

vi. Concert parties

In the MBO of a publicly listed company, it is very important to establish who will be treated as acting in concert with the offeror, not only because of certain disclosures relating to concert parties made in the offer document, but also because of the general application of Rule 4.2,[220] Rule 5,[221] Rule 6,[222] Rule 9[223] and Rule 11[224] of the City Code.

In a takeover transaction involving an MBO, the venture capitalist funding the MBO will be treated by the Panel as acting in concert with the Newco and the management team.[225] The senior debt lender as a clearing bank which provides a loan facility to Newco will not normally be treated as automatically acting in concert with Newco. However, the Panel has previously ruled that a bank which was to receive warrants to subscribe for shares in Newco or convertible loans as part of the terms of its facility agreement would be so treated, therefore, the Panel ought to be consulted.[226] It is not unusual for a mezzanine lender to receive warrants on an MBO. If this is the case, the Panel should be consulted to determine whether the mezzanine lender will be deemed to be acting in concert with the Newco.[227] Finally, the relatives of the management team will normally automatically be presumed by the Panel to be acting in concert with Newco.[228]

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220 Rule 4.2 regulates the selling of shares in Target during the offer period.
221 Rule 5 provides timing restrictions on acquisitions.
222 Rule 6 sets forth purchase before the offer period.
223 Rule 9 lays down the parameters for when Newco would have to make a mandatory offer for Targe, rather than a voluntary offer, which is undesirable in view of the very limited conditions which Newco would be committed to attach to its offer. See also Maurice, Dwyer, *Private Equity Transactions*, looseleaf (London: Sweet & Maxwell, 2003) at para. 15.13.
224 Rule 11 could oblige Newco to make a cash alternative available to Target's shareholders, when Newco might not have wished to do so.
225 City Code, Definition of "Acting in concert", Note 5 and Rule 9, Note 4. See also Maurice Dwyer, *Private Equity Transactions*, *supra* note 58 at para. 15.14.
226 Maurice Dwyer, *Private Equity Transactions*, *supra* note 58 at para. 15.15.
227 Spencer Summerfield, *supra* note 158.
228 City Code, Definition of "Acting in concert", Note 2.

2. Management bidders for a listed target should also have regard to guidelines published by the Institutional Shareholders' Committee Guidelines.

In addition to the requirements of the City Code, management bidders for a listed target should also comply with the guidelines published by the Institutional Shareholders' Committee ("ISC").[229] The ISC, representing the interests of pension funds, insurance offices, unit trusts, investment trust companies and the asset management arms of merchant banks and securities house[230], has worked closely with the Panel on Takeovers and Mergers. Although it is obvious that the ISC guidelines do not have force of law, failure to comply with the guidelines may have an adverse effect on management's future relations with the City and the prospects of the offer succeeding, as with the City Code.[231]

In December 1989 ISC issued a more detailed Guidance Note to those involved in management buy-outs.[232] In April 1991, ISC published a statement of the role and duties of directors including guidelines on management buy-outs.[233] The guidelines deal with several key areas of concern:

A. Independent non-executive directors

The ISC favours the presence of independent non-executive directors on boards of quoted

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[229] Maurice Dwyer, *Management buyouts, supra* note 140 at para. 14.06.
[230] In 1991 the members of the Institutional Shareholders' Committee were: the Association of British Insurers; the Association of Investment Trust Companies; the British Merchant Banking and Securities Houses Association; the National Association of Pension Funds; and the Unit Trust Association. In 2002, the members are: the Association of British Insurers; the Association of Investment Trust Companies; the National Association of Pension Funds; and the Investment Management Association. ISC Statement of Priciples October 2002 online: IVIS Institutional Voting Information Service <http://www.ivis.co.uk/pages/gdsc6_5.html>.
[231] Maurice Dwyer, *Management buyouts, supra* note 140 at para. 14.06.
[232] Spencer Summerfield, *supra* note 158.
[233] *Ibid.*

companies.[234] The content of the guideline is: "A management buy-out proposal is unlikely to be favourably received unless it is made by the executives of a company on the board of which there is, and has been for some time, a strong independent, non-executive presence."[235]

B. Independent advisers

The ISC's view is that in the event of an management buy-out proposals, it is not appropriate for a management team to employ the professional advisors who have previously been employed by the target company, unless independent non-executive directors advise that the interests of shareholders would not be adversely effected by such an arrangement between the management team and the advisors or virtually might be better protected by the appointment of new advisors.[236] Bidders should not have access to the company's usual professional advisers, since this would aggravate the conflict of interest.[237]

C. Recommendation

In line with the guidelines, it is most unlikely that a management buy-outs proposal would receive a sympathetic response unless they were supported and recommended by those independent non-executive directors of the target company.[238]

D. Holders of debentures and loan stock and other bonds

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[234] ISC Guidelines on Management Buy-outs December, 1989, 3.1, online: IVIS Institutional Voting Information Service <http://www.ivis.co.uk/pages/gdsc6_4.html>.
[235] ISC Guidelines on Management Buy-outs December, 1989, 3.1.1, online: IVIS Institutional Voting Information Service <http://www.ivis.co.uk/pages/gdsc6_4.html>.
[236] ISC Guidelines on Management Buy-outs, December 1989. 3.2.1, online: IVIS Institutional Voting Information Service <http://www.ivis.co.uk/pages/gdsc6_4.html>.
[237] ISC Guidelines on The Role and Duties of Directors April 1991, 10.2(c), online: IVIS Institutional Voting Information Service < http://www.ivis.co.uk/pages/gdsc6_1.html>.
[238] ISC Guidelines on Management Buy-outs, December 1989. 3.3.1, online: IVIS Institutional Voting Information Service <http://www.ivis.co.uk/pages/gdsc6_4.html>.

A proposal for a management buy-out should take account of the concerns of holders of any debentures, loan stocks and other bonds, and management should state at the same time as the announcement of the terms of their offers, their intentions with regards to such stocks and clarify any consequential changes in asset or income cover, if the debentures, loan stock and other bonds are to remain in issue.[239]

E. Sufficient Information disclosure

The directors of a target company must use their best endeavours to ensure that there is made available to shareholders sufficient information to enable them properly to assess the value of the company or other assets which it is proposed to sell.[240]

F. Separate Committee.

According to the guidelines, the board of a target company should appoint a separate committee consisting wholly or mainly of non-executive directors with direct access to independent advisers. Independent advisers should have access to all information necessary to enable them to give a fully informed opinion as to the merits of the offer. The committee should be responsible for a separate statement to shareholders, giving the views both of itself and of the independent advisers on the bid.[241]

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239 ISC Guidelines on Management Buy-outs, December 1989. 3.4, 3.4.1, online: IVIS Institutional Voting Information Service <http://www.ivis.co.uk/pages/gdsc6_4.html>.
240 ISC Guidelines on The Role and Duties of Directors April 1991, 10.2(a), online: IVIS Institutional Voting Information Service < http://www.ivis.co.uk/pages/gdsc6_1.html>.
241 ISC Guidelines on The Role and Duties of Directors April 1991, 10.2(b), online: IVIS Institutional Voting Information Service < http://www.ivis.co.uk/pages/gdsc6_1.html>.

3. A MBO of a listed company may also be governed by the relevant provisions of Listing Rules of the London Stock Exchange

A Management buy-out of a listed company or a subsidiary of a listed company may also be governed by the provision of the Listing Rules of the London Stock Exchange.

The main significance of the current Listing Rule is that management buy-outs of listed companies are classified by Chapter 11 as “Transactions with Related Parties”. This chapter provides certain safeguards against current or recent directors taking advantage of their position. Where any transaction is proposed between a listed company or any of its subsidiaries and a related party, a circular and the prior approval of the company in general meeting will generally be required. And the related party should not be permitted to vote at the meeting. It makes clear that a director and shadow director of not only the listed target company but also any of its subsidiaries and an associate of such director will constitute a “Related Party” for the purpose of deciding whether shareholders’ approval is required.[242]

A management buy-out is highly unlikely to be a transaction between Target and the director himself, it will be between Target and Newco. However, the director and his colleagues are likely to have an equity shareholding in Newco. According to the definition of “associate”[243], where directors of the target or any of its subsidiaries will hold 30 percent or more of the voting share capital of Newco on completion of the management buy-out, the management buy-out will be a related party transaction unless it falls within the scope of certain exceptions

[242] The Listing Rules, Chapter 11, Paragraph 11.1(b).
[243] The Listing Rules, Chapter 11, Paragraph 11.1(d)(iii).

from the requirements for "small" transactions clarified by Chapter 11.[244] Therefore, the target will be required to make any announcement including information specified in para.10.31, details of the related party and the nature and extent of the interest of the related party, to send a circular to shareholders of such information, to obtain the approval of shareholders, and to ensure that both the related party and its associates abstain from voting on the resolution to approve the transaction.[245]

IV. Financial Assistance and MBOs under Section 151 of the Companies Act 1985

1. Introduction

A. Background

Because of the leveraged nature of the management buy-out transactions, the provisions of section 151 of the Companies Act 1985 which prohibits the giving of financial assistance by a company for the acquisition of its own shares have particular relevance to MBOs.[246] The principal objective of these provisions is to prevent the abuses which may likely arise where a purchaser relies on the funds of a company to finance the acquisition of the control of the company in circumstances where he is not able to provide the funds necessary to acquire the control of the company either from his own resources or by borrowing on his own credit.[247] Thus, these provisions are designed to prevent a company from providing financial assistance for the purchase of its own shares and thereby to protect the company's creditors against shareholders realizing the assets of the company ahead of creditors.

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244 The Listing Rules, Chapter 11, Paragraph 11.7, 11.8.
245 The Listing Rules, Chapter 11, Paragraph 11.4.
246 Weinberg & Blank, *supra* note 5 at para. 2-6006.
247 *Ibid.* at para. 2-7002.

The provision of financial assistance is most likely to come sharply into focus in the context of a management buy-out when the offeror has few assets of its own but intends to pay for the bid by borrowings which will be serviced and/or secured by the money and assets of the target. Notwithstanding the new readiness of lenders to rely on cash flow rather than assets as security for their lending, lenders will frequently seek a charge over the assets of a company subject to an MBO.[248] If the bid is financed by equity then this is less of a problem, but if offeror is to borrow money to acquire the shares in the target, it is likely that the lenders will want security not only over the shares in the target, but also over the underlying assets of the target and its subsidiaries. In addition, the lenders will wish to ensure that there is a mechanism in place for cash generated by the target to be used to repay the borrowings of the offeror.[249]

To obtain the funding for the MBO, it may be necessary for the target company to charge all or some of its assets in favour of the lenders to the MBO vehicle. In entering into such arrangements it is important that the target company and its directors do not contravene the prohibitions on financial assistance provisions contained in the Companies Act 1985, and such arrangements would not give rise to both civil liability and criminal penalties for the target company and its directors.

B. History

[248] *Ibid*. at para. 2-6006.
[249] Graham Stedman, *supra* note 175 at para. 21.6.2.

It is often said that the relaxation of the rules prohibiting companies from providing financial assistance in connecting with purchases of their own shares in 1981 opened the door for the development of management buy-outs in UK.

Historically, the prohibition on the giving of financial assistance derives from the "capital maintenance doctrine" in *Trevor* v. *Whitworth.*[250] As with the restrictions on the ability of a company to repurchase its own shares, the prohibition on financial assistance is intended to prevent the improper return of capital to the company's shareholders. It is supposed to provide some assurance that the company's assets will not be unlawfully depleted to the detriment of creditors and minority shareholders.[251]

The potential for abuses from improper financial assistance was early recognized and legislative prohibition was recommended in the Greene Committee Report in 1926.[252] As a consequence of the finding of the Committee in this regard, a section was introduced in Section 45 of the Companies Act 1929 to curb these abuses. Subsequent revisions were set forth in Section 54 of the Companies Act 1948.[253] The purpose of the law was to protect creditors and shareholders against an unauthorized reduction of capital and to prevent the

[250] *Trevor* v. *Whitworth* (1887) 12 App. Cas. 409 (HL). In this case, persons lending money or granting credit to a company are entitled to rely upon the existence of the issued capital of the company (subject to business losses) as a cushion against the possibility of the company being unable to repay its debts.

[251] Stephen Kenyon-Slade, *supra* note 142 at para. 7.89.

[252] See *Report of the Company Law Amendment Committee, Cmnd 2657* (1926), at para. 30. The Greene Committee Report described the following situation: "A practice has made its appearance in recent years which we consider to be highly improper. A syndicate agrees to purchase from the existing shareholders sufficient shares to control a company, the purchase money is provided by a temporary loan from a bank for a day or two, the syndicate's nominees are appointed directors in place of the old board and immediately proceed to lend to the syndicate out of the company's funds (often without security) the money required to pay off the bank. Thus, in effect the company provides money for the purchase of its own shares. This is a typical example although there are, of course many variations. Such an arrangement appears to us to offend against the spirit if not the letter of the law which prohibits company from trafficking in its own shares and the practice open to the gravest abuses."

[253] Paul L. Davies, supra note 56 at 259-261.

acquisition of companies with the use of the company's own funds.[254]

The relaxation of the law relating to the provision of financial assistance by companies for the purpose of the acquisition of their own shares in Sections 42-44 of the Companies Act 1981 is said to have provided significant stimulus to the development of management buy-outs.[255] These sections introduced substantial relaxations on what was previously a comprehensive prohibition on companies providing financial assistance in connection with acquisitions of their shares or their holding company's shares.

The current legislation is now to be found in Chapter VI of Part V (Sections 151 to 158) of the Companies Act 1985. The principal objective of the financial assistance provisions is to prevent the depletion of a company's capital where such depletion is likely to be contrary to the interests of the company, its shareholders or its creditors.

The new legislation relaxed the law set forth in and developed from Section 54 of the Companies Act 1948 in three significant ways. First, it contains a definition of financial assistance, now to be found in Section 152 of the Companies Act 1985. Secondly, the prohibition against financial assistance will not be breached by a transaction under Section 153 of the Companies Act 1985. Section 153 establishes various exceptions to the general prohibition - including the "principal" and "larger" purpose exceptions. Thirdly, there is a general relaxation of the prohibition for private companies provided that they comply with

[254] Debbie Anthony, *supra* note 11 at 110.
[255] *Ibid.*

Sections 155 to 158 of the Companies Act 1985. Sections 155 to 158 relax the prohibition for private companies where the company's net assets are not reduced or the assistance is given out of distributable profits, and the "whitewash" procedure set out in those sections is followed.[256]

C. Reform of Sections 151 to 158

In 1993, the Department of Trade and Industry(DTI) published a consultation document on reform of the law in relation to financial assistance in s.151 of the Companies Act 1985, which said that the provision had been criticised "as being uncertain in scope and liable to prohibit some transactions which may be innocent or in the interest of the company".[257] That consultation followed the House of Lords case of *Brady* v *Brady*(see below),[258] which gave a very narrow interpretation to one of the key exemptions to the prohibition, namely where there is another principal or larger purpose to the transaction. More than ten years on, the proposals for reform have made no progress and another group of cases, in particular the Court of Appeal decision in *Chaston* v *SWP Group Plc*[259] have increased the level of uncertainty for companies and their advisers.

Section 151 must be one of the most scrutinized sections in the Companies Act. Breach is a criminal offence and can result in personal liability in damages for the directors of the company. As the *Chaston* case shows, breach of s.151 is a breach of fiduciary duty even if the

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256 Richard Barham, "Financial Assistance: Proposals for Reform" (1994), ICCLR 1994, 5(2), 39-42.
257 Company Law Review: Proposals for Reform of ss.151 - 158 of the Companies Act 1985, October 1993.
258 *Brady* v. *Brady* [1989] AC 755 (HL).
259 *Chaston* v *SWP Group Plc* [2002] EWCA Civ 1999. [2003] B.C.C. 140 (CA).

directors genuinely believed that they were acting in the best interests of the company. It is also noted from recent cases that liquidators and counter-parties on transactions will have no hesitation in seeking to rely on s.151 if things subsequently go wrong.

The latest cases all require those advising on the section to look at the commercial substance of the particular transaction but the consequence of this is, according to the Court of Appeal in *MT Realisations Ltd (In Liquidation)* v *Digital Equipment Co Ltd*,[260] that "the authorities provide useful illustrations of the variety of fact situations in which the issue can arise, but it is rare to find an authority on s.151 which requires a particular result to be reached on different facts". This is not likely to bring any comfort to a corporate lawyer trying to give definitive advice to a client on whether a particular course of action could be in breach of s.151. A "may be" answer is not sufficient. The result is significant additional cost for companies in legal advice and in restructuring transactions to try to avoid the financial assistance problem arising.[261]

Thus, the provisions are under review in company law reform processes by the DTI as a result of the uncertain application of various provisions and after the doubts raised by the decision of the House of Lords in *Brady* v. *Brady.*[262] The DTI acknowledged that the current provisions have proven to be notoriously difficult to interpret and made proposals for the further relaxation of the provisions to clarify and simplify the law. The DTI produced its first proposals for reform, comprising a single scheme for public and private companies in October

[260] *MT Realisations Ltd (In Liquidation)* v *Digital Equipment Co Ltd* [2003] EWCA Civ 494.
[261] Carol Shutkever, "Financial Assistance" (2004), Comp. Law. 2004, 25(2), 34.
[262] *Brady*, *supra* note 258. See also *Chaston, supra* note 259.

1993,[263] but in their own words, it became clear that their suggested draft legislation "ran a serious risk of producing a result even more complex, and obscure, than the present legislation". The DTI has, therefore, tried again,[264] this time proposing separate schemes for public and private companies,[265] And DTI produced a further proposal document taking into account responses received, in April 1997.[266]

The failure to make any progress in reforming the law on financial assistance is an example of one of the unfortunate side effects of the proposed overhaul of company law first announced by the DTI in 1998.[267] This is that the specific areas of law previously identified as being ripe for reform, and the subject of various DTI and Law Commission reform papers, have all now been bundled into the over-arching review process, rather than being progressed as separate reform proposals. This was well and good when the new Companies Bill to replace the 1985 Act was announced on its original time track.

The Company Law Review Steering Group[268] set up to start the process of the company law review, recommended that the prohibition of financial assistance should be removed from private companies entirely. In relation to public companies, any reform of sections 151 to 158 is limited by the need for the United Kingdom to comply with Article 23 of the Second

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[263] DTI's Consultative Document on proposals for reform of sections 151 to 158 Companies Act 1985: financial assistance by a company for the purchase of its own shares.(B.J.I.B. & F.L. 1993, 8(11), 566-567).

[264] Company Law Reform: Financial Assistance by a Company for the Acquisition of its Own shares (DTI November 21, 1996)

[265] Jennifer Payne, "Financial Assistance for the acquisition of shares" (1997), COMPLAW 1997, 18(6), 186-187.

[266] Company Law Reform: Financial Assistance by a Company for the Acquisition of its Own shares (DTI, April 21, 1997).

[267] Carol Shutkever, *supra* note 261.

[268] The Steering Group was formed of those with particular knowledge and expertise in company law matters to over see the management of the Review of company law.

Company Law Directive of the European Union[269]. This does not however prevent an overhaul of the wording itself to clarify its application.[270]

In July 2003 the Government announced its plan to change company law. Part of the reform relates to capital maintenance, which includes proposals for reforming the financial assistance legislation. The Government welcomes the Review's proposals to simplify this capital maintenance regime, particularly for private companies and to make it more accessible and easy to use. The major recommendations were the removal of the prohibition on the giving by private companies of financial assistance for the acquisition of their own shares and the revision of some of the existing exemptions from the prohibition on financial assistance, and the introduction of new exemptions.[271] The Government intends to consult on clauses implementing such financial assistance recommendations in due course.

2. The general prohibition and applicability to MBOs

As discussed above, in applying Section 151, it is important to note the different treatment given to public companies, as opposed to private companies. Sections 151 and 152 apply to both public and private companies for the acquisition of their own shares, but subject to a relaxation in relation to private companies if they comply with sections 153 to 158.

A. Section 151- the general prohibition

[269] 77/91: [1977] O.J. L26/1. The wording of Article 23 of the Second Company Law Directive, which applies to public companies only, approaches the question of capital maintenance in a less detailed way. Article 23 provides that a company may not advance funds nor make loans, nor provide security with a view to the acquisition of its shares by a third party.

[270] Carol Shutkever, *supra* note 261.

[271] White Paper 'Modernising Company Law' (Cm 5553) published on 16 July 2002. For full text please see online: < http://www.dti.gov.uk/companiesbill/whitepaper.htm>.

Section 151 of the Act is often regarded as an extension of the protection given to shareholders and creditors against erosion of the company's capital. It provides that it is unlawful for a company, or any of its subsidiaries, to give financial assistance, whether directly or indirectly, to enable a person to acquire shares in the company or to reduce or discharge a liability incurred in the purchase of such shares. The prohibition applies regardless of whether the financial assistance is given directly by the company to the purchase of its shares, or is first given to another party which in turn transfers the financial assistance to the ultimate purchases.[272]

Compared with earlier legislation, Section 151 draws a distinction between financial assistance given before the purchase of the company's share and financial assistance given afterwards. Subject to the applicable exception, under Section 151(1), "where a person is acquiring or is proposing to acquire shares in a company, it is not lawful for the company or any of its subsidiaries to give financial assistance directly or indirectly for the purpose of that acquisition before or at the same time as the acquisition takes place." Section 151(2) provides that subject to the same exception, when a person has acquired shares in a company and any liability has been incurred (by him or any other person) for that purpose, it is not lawful for the company or any of its subsidiaries to give financial assistance directly or indirectly, for the purpose of reducing or discharging that liability.

A company acting in contravention of Section 151 is liable to a fine and its defaulting officers

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[272] *Charterhouse Investment Trust* v. *Tempest Diesels Ltd.* [1986] B.C.L.C. 1.

to imprisonment or a fine, or both.[273] However the prohibitions do not deal with the consequences of a breach of section 151 with regard to the validity of the transactions in question. In management buy-outs one of the most significant consequences will be that any guarantees, charges or debentures given to funding banks will be unenforceable by them if given in breach of the prohibitions.[274]

It should be noted that Section 151 does not prohibit a foreign subsidiary from giving financial assistance for the purchase of shares in a UK parent company.[275]

B. The meaning of financial assistance in Section 152 and the applicability of Section 151 to MBOs.

So what types of "financial assistance" within the meaning of Section 151 can be involved in management buy-outs? Section 152(a) provides a relatively broad description of "financial assistance" for purpose of Section 151. In addition to such obvious assistance as gifts, loans, guarantees, releases, waivers and indemnities (other than an indemnity in respect of the indemnifier's own neglect or default), financial assistance includes any loans, or other agreement under which the obligations of another party to the agreement, and the novation of a loan or of such other agreement, or the assignment of rights under it.[276] Also it includes any other financial assistance given by the company the net assets of which are thereby reduced or which has no net assets.[277] However it does not provide the definition of what amounts to a

[273] Section 151(3) of the Companies Act 1985.
[274] *Heald* v. *O'Connor* [1971] 1 W.L.R. 497.
[275] *Arab Bank* v. *Mercantile Holdings* [1994] 1 B.C.L.C. 330.
[276] Section 152(a)(i)(ii)(iii) of the Companies Act 1985.
[277] Section 152(a)(iv) of the Companies Act 1985.

material reduction of net assets in the context. This point was discussed in *Parlett* v. *Guppys (Bridport) Ltd,*[278] where Nourse L.J. stated that "there can be no rule of thumb in such a matter and that the question is one of degree to be answered on the facts of the particular case."[279]

The legislation lists a number of specific examples, but it is obvious that the list is not exhaustive. The reasoning of Hoffman J. in *Charterhouse Investment Trust* v. *Tempest Diesels Ltd*[280] was considered by Arden J. in the recent case *Robert Chaston* v. *SWP Group PLC,*[281] and the Court stated that "the question whether financial assistance exists in any given case may be fact-sensitive and not one which can be answered simply by applying a legal definition.

As the precise scope of the prohibition has been a matter of uncertainty for practitioners in management buy-outs, the most common example of financial assistance to be found in management buy-outs are as follows according to Section 151.[282]

The provision by the target or its subsidiaries of guarantees and charges in favour of to the Newco's lenders to funding the buy-out of the borrowing obligations of Newco incurred for the purpose of funding the acquisition of target's shares falls within Section 151(1)(a)(ii).

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278 *Parlett* v. *Guppy (Bridport) Ltd*. [1996] 2 B.C.L.C. 34.

279 Lucy Lambert, "The Meaning of "Financial Assistance" in S.151." Case Comment on *Parlett* v. *Guppy (Bridport) Ltd*, COMPLAW 1997, 18(8), 272.

280 Hoffman J. stated that because "the words have no technical meaning" it was important to construe them in the context of "the language of ordinary commerce" and adopt a pragmatic approach in determining what transactions amounted to giving "financial assistance".

281 *Chaston*, s*upra* note 259.

282 Graham Stedman, *supra* note 175 at para. 21.6.3.

The provision of a loan by a target to Newco to enable it to meet the purchase price (financial assistance before transactions) or to help to discharge borrowing incurred by Newco and used to pay the purchase price (financial assistance after transactions) in both cases falls within Section 151(1)(a)(iii).

The repayment by target or one of its subsidiaries of an intra-group loan owed to the vendor as part of the arrangements being put in place before completion of buy-out will fall within Section 151(1)(a)(iv), if the repayment were materially reduce the net assets of repaying company or were make earlier that its due date.[283]

The "hive up" of the target's business and assets to Newco following the transaction falls within Section 151(1)(a)(iii), where it is often done at market value but with the consideration for the transfer payable by Newco to Target left outstanding as a loan owing by Newco.

It is sometimes arguable that the payment of the legal, accountancy and other professional fees incurred in connection with the buy-out to be paid by Newco would not constitute financial assistance. The reasoning here is that the payment of fees is not for the purpose of the subscription for shares and is not sufficiently closely connected to provide financial assistance for the subscribers to pay subscription monies. Reliance might also be place upon on the "principle purpose" exemption contained in Section 153 as below. The DTI has

[283] Plaut v Steiner (1988) 5 B.C.C. 352. See also British & Commonwealth Holding Plc v. Barclays Bank Plc [1996] 1 W.L.R. 1, CA.

proposed reforms which would make an exemption available for legitimate costs connected with the issue and transfer of shares so as to remove the uncertainty in this area.[284]

3. Exemptions to Section 151 and applicability to management buy-outs

There are four categories of exemption contained in the Companies Act 1985. The first two apply equally both to public and private companies; the third one applies to both but with more limitations for public companies; and the fourth applies to private companies only. These are considered below.[285]

A. First category: "Principal purpose" exception

Section 153 provides specific exceptions to the prohibition under Sections 151(1) and (2). In general, financial assistance will be permissible where it is given both in good faith in the interests of the company and the company's "principal purpose" is not for the acquisition of its own shares, nor to reduce or discharge a liability incurred by the purchaser.[286] The "principle purpose" exception is intended to ensure that legitimate business transactions do not inadvertently breach Section 151.

Although the question of what a company's "purpose" in giving assistance is appears to be a subjective test, the court in *Brady* v. *Brady*[287] decided, on a narrow interpretation of "purpose",

[284] White Paper "Modernising Company Law" (Cm 5553) published on 16 July 2002. For full text please see online: < http://www.dti.gov.uk/companiesbill/whitepaper.htm>.
[285] Graham Stedman, *supra* note 175 at para. 22.1.5.
[286] Sections 153(1), 153(2)) of the Companies Act 1985.
[287] In *Brady*, two brothers, Bob and Jack , carried on various businesses under the umbrella of Brady Ltd. including a haulage business and a drink business. After an irreconcilable argument, they agreed to divide the business and its assets equally between them. An agreement was drafted to memorialize those intentions, but this was later effused by Bob who alleged that the assets had been unfairly divided. Jack then brought an action for specific performance of the agreement. Bob argued that the agreement was illegal in so far as it involved the giving

it had little to do with the director's motives. In this remarkable case, the trial judge held the principal purpose of the financial assistance was to resolve the conflict and deadlock between the brothers and to rescue the business. However, the House of Lords rejected this reasoning. The Court accepted that the reason for the provision of the financial assistance was more important than the relevant acquisition of shares and it was given in good faith in the interests of the company. Nevertheless, the court pointed out that "purpose" had to be distinguished from "reason" or "motive", and held that the principal purpose was to enable shares to be acquired, and therefore the transaction did not fall under the "principal purpose" exception. It is generally considered by practitioners that the *Brady* case has substantially reduced the scope for relying on the "principal purpose" exemption.

Accordingly, the DTI proposes in its White Paper of July 2002 to revise some of the existing exemptions from the prohibition on financial assistance and introduce new exemptions. It is believed that the principal purpose exemption will be revised. It can be seen that the DTI proposes that the exemption from the prohibition on financial assistance for transactions whose principal purpose was not the acquisition of shares should be reformulated in terms that the acquisition of shares was not the predominant reason for the transaction.[288] The change of focus appears to lower the test allowing more scope for the practitioner to argue that the transaction fits within the general exception. However such optimism should be treated with caution in the context of management buy-outs, because it will be likely that in

of the financial assistance by Brady Ltd towards discharging the liability for the purchase of its own shares.

[288] Chapter 7.14 of Modern Company Law for a Competitive Economy-Completing the Structure (November 2000). For full text please see online: < http://www.dti.gov.uk/cld/reviews/comstruc.htm>.

all circumstances the pre-dominant reason for a transaction is the acquisition of the shares.[289]

B. Second category: Specific exempt transactions- Section 153(3)

In addition, Section 153(3) specifies a number of transactions which are not unlawful if they comply with statutory procedures and in certain cases receive judicial approval.

This exemption can be used in the context of management buy-outs. Firstly, the payment of a lawful dividend by the target out of its distributable profits does not amount to financial assistance.[290] Thus the target must have sufficient distributable profits and available cash and the dividend must be paid in accordance with the target's memorandum and articles of association and in compliance with Sections 263-281 of the Companies Act 1985. The Newco shall acquire 100% of the target unless it is willing to pay a large dividend to the remaining minority.

Secondly, it may be possible in certain instances to incorporate the buy-out proposals for financial assistance as part of Court Scheme where this method of effecting the buy-out is practicable.[291] A Court Scheme is appropriate for a management buy-out, particularly where the lenders to the buy-out team wish to use the target's assets as security for their loans without any objection from a minority of the target's shareholders. A scheme can be approved by a majority in number representing three-fourths in value of the members present and

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289 David Cabrelli, "In Dire Need of Assistance?: Sections 151-158 of the Companies Act 1985", J.B.L. 2002, May, 272-291.
290 Section 153(3)(a) of the Companies Act 1985.
291 Section 153(3)(e) of the Companies Act 1985.

voting either in person or by proxy at a special meeting convened at the direction of the court and sanctioned by the court.[292] Anything done pursuant to a scheme under section 425 of the Companies Act is exempt under Section 153(3)(e) and hence if the proposed financial assistance is part of a scheme and is approved by the court, it will be permitted.

C. Third category: Lending in the ordinary course of business and employee share ownership - Section 153(4)

Section 153(4) provides exceptions for certain specific transactions such as those conducted in the ordinary course of business and for the purchase of shares under employee share ownership schemes so long as it is in good faith in the interests of the company. However, the extent of the exceptions under Section 153(4) is limited by Section 154(1) for a public company. Thus a public company may only rely on such exceptions if the company has net assets which are not thereby reduced if the assistance is provided out of distributable profits.

D. Fourth category: The “Whitewash procedure”

i. “Whitewash procedure” under Sections 155 to 158 and its applicability to MBOs

In addition to the exceptions described above, it is not uncommon in management buy-outs for the purchasing company to take advantage of Sections 155 to 158 of the Companies Act 1985. These sections set out the procedure which permits a private company, not a public one, to give financial assistance for the acquisition of its own shares, otherwise prohibited by

[292] Graham Stedman, *supra* note 175 at para. 21.6.6.

Section 151 -- commonly known as a financial assistance whitewash.[293] There is also a restriction on the use of the sections by subsidiary private companies in a group with public companies.[294]

Private companies may provide financial assistance, provided they can fulfill the requirements of sections 155 to 158--the “Whitewash procedure”. At present, this is the most common method used by practitioners as a means of ensuring that the assistance is not classified as prohibited. In reality, where only private target companies are involved, this will prove the most desirable approach in management buy-outs where borrowings obtained from a bank by the newly incorporated company are secured by the assets of the target and its subsidiaries.[295]

However, where the target is not a private company, but a publicly listed company, the Section 151 prohibition on financial assistance significantly affects the structure of management buy-outs and other such leveraged transactions in which purchasers look to the Target’s cash flow and assets to repay and secure debt that was incurred to acquire the company.[296] In practice, such transactions are effected by re-registering the publicly listed target company as a private company so that it can take advantage of the “whitewash procedure”.[297] By following the steps set out in the whitewash procedure, a private target

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[293] But there is nothing to stop a public company from registering as a private company to take advantage of the provisions and then re-registering as a public company as discussed above.
[294] Section 155(3) of the Companies Act 1985.
[295] David Cabrelli, *supra* note 289.
[296] Stephen Kenyon-Slade, *supra* note 142 at para. 7.107.
[297] In short, a public company is one which is said to be a public company by its memorandum, and which is registered as such under the Companies Act 1985. A public company must have at least two members and its name must end with the words “public limited company” or “PLC”. A public company must at a minimum allot to its members shares with a nominal value of £50,000, although it is permissible for the members to pay up only 25% of the nominal value of the shares. By contrast, a private company limited by shares is one which is not a public company. The word “limited” or “Ltd.” typically follows the name of the company. The private company may have

company is permitted to grant financial assistance for the acquisition of its shares.[298] Converting to a private company requires a special resolution (75% approval of those voting).[299] However, such a resolution can be challenged. As the re-registration may adversely affect minority shareholders, the holders of 5% or more in nominal value of the target's issued shares, or any class thereof, or 50 or more of its shareholders who did not vote in favour of the resolution may apply within 28 days to the court for a cancellation of the re-registration.[300] Accordingly, only by acquiring over 95% or reducing the minority below 50 shareholders can Newco be sure of successfully converting the target into a private company for this purpose.

ii. Requirements for application of "whitewash procedure"

There are some conditions to be satisfied for the provision of the financial assistance. These requirements are complex, and there are even more complexities over timing.[301]

The first condition is that the assistance may only be given if the company has net assets which are not thereby reduced or to the extent that they are reduced, if the assistance is provided out of distributable profits.[302]

This requirement means that in the most common case of financial assistance on a management buy-out such as the provision of guarantees and charges by the target and its

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only a token amount of contributed capital, eg. £1, and may have only one member. Importantly, only the shares of a public company may be listed on a stock exchange. A publicly listed company will always be a public company.

298 For full discussion, see Spencer Summerfield & Chiris Hale, "From Public to Private: Management Buyouts of Listed Companies" (1998) PLC 9(5), 1, 1998, 21-28. See also Stephen Kenyon-Slade, *supra* note 142 at para. 7.109.

299 Section 53 of the Companies Act 1985.

300 Section 54 of the Companies Act 1985.

301 David Wainman, *Company Structure: Law, tax and accounting for companies and groups, growing and evolving*, 2nd ed. (London: Sweet & Maxwell, 1999) at para. 9.21.

302 Section 155(2) of the Companies Act 1985. "Net assets" is defined in Section 154(2) and "distributable profits" is defined in Section 152(1)(b).

subsidiaries, it must be determined whether or not the provision of such security will reduce net assets. In practice, the banks may require the target's auditors as a condition of providing debt funding to provide a "non-statutory auditor's report" stating the compliance with the "net assets" requirement.[303] Also, a letter from the auditors may be required by the banks to demonstrate that they have not been reckless in satisfying themselves as to any potential infringement of the financial assistance prohibition.[304] Whether the entering into of the guarantee and charges creates a liability which may reduce such net assets, current accounting practice is to reach a view as to whether or not the relevant guarantee will be called within the foreseeable future. If such a guarantee is likely to be called, it would constitute a liability within the meaning of section 154(2)(b) and would therefore have to be taken into account in calculating net assets. If this is the case, the amount of the reduction in the net assets will make it impossible to utilize the whitewash procedure.[305]

The next requirement is if the target is not a wholly-owned subsidiary (ie. 100% of the target's shares are not acquired by Newco), the giving of financial assistance must be approved by a special resolution of the company in general meeting or written resolution under Section 318A.

The third requirement is that all the directors must make a statutory declaration confirming the projected solvency of the company for the next 12 months.[306] A statutory declaration made

[303] Maurice Dwyer, *Private Equity Transactions*, *supra* note 58 at para. 11.20.
[304] *Eagle Trust plc* v. *SBS Securities Ltd* [1991] B.C.L.C. 438.
[305] Maurice Dwyer, *Private Equity Transactions*, *supra* note 58 at para. 11.21.
[306] Section 155(6) of the Companies Act 1985.

by the company's directors must contain such particulars of the financial assistance to be given, and of the business of the company of which they are directors, and shall identify the person to whom the financial assistance is to be given.[307] It is advisable to set out in as much detail as possible in the declaration a description of the nature of the financial assistance.[308]

However, the major area of uncertainty which exists in connection with the making of the statutory declaration concerns the appropriate treatment of contingent and prospective liabilities. Also the procedures for the giving of the declarations and the particulars to be shown on the form are unclear.[309]

In the context of management buy-outs, the case of *Re SH & Co (Realisations) 1990 Ltd*[310] provides guidance for advisors on the meaning of Section 156 and the proper completion of the statutory declaration. The particulars in the statutory declaration did mention a debenture but did not state what property had been charged, nor the nature of the charge nor the fact that a guarantee had been given. Lord Mummery J held that the matters omitted did not prevent the particulars that had been given from complying with the requirements of s. 156 of the Act so that the statutory declaration in question had satisfied the statutory requirement, albeit it

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[307] Section 156(1) of the Companies Act 1985.
[308] *Re SH & Co (Realisations) 1990 Ltd* [1993] B.C.C. 60 (Ch D).
[309] Gary Senior, "Financial Assistance: The Perils of the Companies Act 1985, S. 155: Problems In Relation To the Directors' Statutory Declaration" (1994), COMPLAW 1994, 15(2), 54-56.
[310] *Re SH & Co (Realisations) 1990 Ltd, supra* note 309. It arose out of the administrative receivership of SH & Co (Realisations) 1990 Ltd ('SH Co') following a management buy-out. A purchasing vehicle, Rolelock Ltd ('R Co') was formed to acquire the entire share capital of SH Co. Nyckeln Finance Co Ltd ('NF Co') lent money to R Co to enable it to acquire the shares of SH Co, thereby effecting the management buy-out. The receivers of the company sought directions whether the debenture was void because the statutory declaration by the directors of SH Co. pursuant to the Section 155 did not contain full particulars of the financial assistance given by the company for the purchase of its shares.

was one which was “close to the line”.[311]

Thus, directors should be aware that the duty imposed by Sections 155-158 is to comply with “objective requirements”not just to use best endeavors to comply with them.[312] However, as the decision was said to be “close to the line”, directors should take care to disclose full particulars so as to avoid any possibility of liability. Care should be taken to include adequate information when completing such a statutory declaration. If there is any cause for concern as to the necessity for inclusion of information, prudence dictates that the information should be provided. As the learned judge aptly put it, advisors in turn should heed the judge’s warning that “solicitors responsible for completing the statutory declaration should err on the side of caution”.[313]

Finally, directors should bear in mind timing considerations under Section 157 and 158. Also, the director’s declaration must be supported by an auditor’s report stating that the auditors have enquired into the state of affairs of the company and are not aware that the opinion stated in the directors’ statutory declaration is unreasonable in all the circumstances. The statutory declaration and auditor’s report must be delivered to the Registrar of Companies either with the special resolution or where no such resolution is required, within 15 days after the making of the statutory declaration.[314]

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[311] *Ibid.*
[312] McKenna & Co, “Financial Assistance: Relaxation of S. 151 for Private Companies” (1993) COMPLAW 1993, 14(5), 104-105.
[313] “Financial Assistance: A Warning to Directors”, Case Comment on *Re SH & Co (Realisations) 1990 Ltd* COMPLAW 1993, 14(4), 77.
[314] Section 156(5) of the Companies Act 1985.

However, even if there is a late filing of the statutory declaration form and the form completed is wrong, the case of *NL Electrial Limited* v. *3i plc*[315] surprisingly holds that the form will be valid. In this case, the statutory declaration was filed 15 days late. However, it was held that, as the legislation provided a specific penalty of a fine for late filing, this should not also invalidate the relaxation procedure. The case also concerned the use of an out-of-date Companies Registry form during the transitional period when the Companies Act 1985 was being brought into force. However, the old and new forms, apart from having different numbers, were identical and this, together with the fact that s 155(6) simply refers to "the prescribed form" but does not specify a particular form, led the court to hold that it made no difference which form was used as long as all the relevant information was given. This decision would probably have been different if the old and new forms had not required precisely the same information to be provided.

Chapter 5: Legal issues concerning MBOs in China

I. Overview of the present legal regime of Chinese law concerning MBOs.

1. Background

Compared with the Common Law legal system, the PRC legal system is a codified system with written laws, regulations, circulars, administrative directives and internal guidelines. The PRC government is still in the process of developing its legal system, so as to meet the needs of investors and to encourage diversified private and foreign investment. Some of the laws

[315] *NL Electrical Ltd* v. *3i plc* [1994] 1 B.C.L.C.22.

and regulations, and the interpretation, implementation and enforcement thereof, are still at an experimental stage and are therefore subject to policy changes.

As the PRC economy is undergoing development generally at a faster pace than its legal system, some degree of uncertainty exists in connection with whether and how existing laws and regulations will apply to certain events or circumstances. For example, as a business vehicle, management buyouts in China have developed over a relatively short period of time and have been constructed around applicable laws rather than having resulted from an evolution of those laws.

The U.K. law relating to management buy-outs is not a self-contained discipline, and the same is true of Chinese law governing management buy-outs. Accordingly, the law relating to buyouts is drawn from many different areas and it is necessary to look at the structures commonly used in management buyouts to know which areas of law are relevant.

2. Legal source

Although the legal source of Chinese laws guiding and governing MBOs is complex, they can be categorized into following main groups.[316]

[316] In accordance with the structure of the lawmaking powers, Chinese law can be divided into four levels. The highest and fundamental law of the PRC is the Constitution. At the second level are laws, resolutions, orders adopted by the National People's Congress(NPC) and its Standing Committee. At the third level are the administrative rules, regulations, decisions and orders of the State Council. The ministries and commissions under the State Council are also authorized to issue orders, directives and regulations within the jurisdiction of their respective departments Ministerial regulations and rules are, in general, more limited in nature and their application is generally within the sphere of the function of the ministry in question. Very often, the ministerial provisions are intended to supplement and implement regulations adopted by the State Council. Finally are the local regulations by the people's congresses of provinces, autonomous regions and cities

A. National legislation adopted by NPC and its Standing Committee

Although the legality of management buy-outs is not established in the Constitution, which is the highest legal authority in China, the ties of national legislation composed of laws adopted by the NPC and its Standing Committee provide general applicable rules concerning the activity.

A management buy-out, as a category of corporate acquisition, is governed by the Company Law of the PRC[317] and the Securities Law of PRC.[318] Meanwhile, as it is impossible to realize a management buy-out without financing by institutional investors who may require relevant guaranties on the target's assets, the Commercial Banks Law of the PRC[319] and the Guaranty Law of the PRC[320] are applicable to the same transaction. There are also scattered provisions regarding management buy-outs in the Income Tax Law of the PRC for Enterprises,[321] the Individual Income Tax Law of the PRC,[322] the Trust Law of the PRC[323] and the Insurance Law of the PRC.[324]

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[317] It was adopted at the Fifth Meeting of the Standing Committee of the Eighth National People's Congress on December 29, 1993, as amended at the Thirteenth session of the Standing Committee of the Ninth National People's Congress on December 25, 1999. For full Chinese text please see online:< http://www.molss.gov.cn/correlate/gsF.htm>.

[318] It was adopted by the Standing Committee of the National People's Congress on 29 December 1998. For full Chinese text please see online:< http://www.bjflzc.com/html/hetong/003.htm>.

[319] It was promulgated by the Standing Committee of the National People's Congress and effective on July 1 1995. It was modified in 2003 and took effective on February 1 2004. For Chinese full text please see online: <http://www.pbc.gov.cn/detail.asp?col=310&ID=16>.

[320] It was adopted at the 14th Meeting of the standing Committee of the Eighth National People's Congress on June 30 1995, and effective as of October 1, 1995. For full Chinese text please see online:< http://www.cin.gov.cn/law/other/2000111609-00.htm>.

[321] It was promulgated by the National People's Congress on January 1 1994.

[322] It was adopted at the Third Session of the Fifth National People's Congress on September 10, 1980 and revised on October 31 1993 and August 30 1999. For Chinese full text please see online: < http://www.sdinfo.net.cn/fagui/content/ba010.htm>.

[323] It was promulgated by the Standing Committee of the National People's Congress on April 28 2001 and effective on October 1 2001. For Chinese full text please see online: < http://www.jincao.com/fa/law09.02.htm>.

[324] It was promulgated by The Standing Committee of the National People's Congress on June 30, 1995, and was amended on October 28, 2002. For Chinese full text please see online: < http://www.people.com.cn/GB/shehui/43/20021029/853076.html>.

However these legislation adopted prior to the explosion of management buy-outs in China do not provide explicit rules of such activities and have caused much complexity and confusion which will be addressed in detail later in this chapter.

B. National legislation issued by the State Council and its ministries

Besides the laws enacted by the NPC and its Standing Committee, the State Council and its ministries have issued many administrative regulations and rules governing such transactions.

i. General regulations

In general, some applicable rules can be applied to the management buy-outs, such as the Measures for the Administration of Disclosure of Shareholder Equity Changes of Listed Companies,[325] the General Rule of Loan,[326] the Administrative Rules on Trust and Investment Companies,[327] and the Provisional Rules on Entrusted Funds Management of Trust and Investment Companies[328]

ii. The landmark legislation of the Measures for Administration of the Acquisition of Listed Companies

It shall be noted that the adoption of the Measures for Administration of the Acquisition of

[325] This measure was promulgated by China Securities Regulatory Commission("CSRC") and come into force on December 1 2002. For Chinese text please see online: < http://www.csrc.gov.cn/cn/jsp/detail.jsp?infoid=1059812607100&type=CMS.STD>.

[326] It was issued by the People's bank of China on June 28, 1996. For Chinese text please see online: < http://www.jincao.com/fa/law09.29.htm>.

[327] It was promulgated by the People's Bank of China and take effective on July 18 2002, for Chinese text please see online: < http://www.fotic.com.cn/Knowledge/K_law/0206_005.htm>.

[328] It was promulgated by the People's Bank of China and took effective on July 18 2002. For Chinese text please see online:< http://www.trustabc.com/read/readnews.asp?id=23822>.

Listed Companies ("the Measures")[329] in December 2002 marked the beginning of Chinese legislation in the management buy-outs sector.

The Measures elaborate upon Chapter IV ("Acquisition of Listed Companies") in the Securities Law of the PRC and provide a full template for the acquisition of control over listed companies. In addition, the Measures provide hints of transfers of illiquid state-owned and corporate shares to non-state actors, which encourage the development of management buy-outs in China.[330]

Most importantly, it was the first time that the Chinese government acknowledged the legality of management buy-outs in the Chinese legislation. Provisions are made for management buy-outs and the role of independent directors in offering separate opinions with respect thereto is strengthened.[331] Besides, the Measures provide the legal basis for other aspects relating to MBOs including director's duties and financial assistance which will be discussed respectively later in this chapter. The purpose of these provisions is to protect the target companies, their creditors and shareholders in such transactions from violations by the involved management.

For the first time in Chinese legislation, the promulgation of the Measures introduces some contents relating to management buy-outs. However, it neither provides an explicit

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329 It was promulgated by the CSRC on September 28, 2002 and just become effective on December 1, 2002. For Chinese text of the Measures, see online: <http://www.csrc.gov.cn/cn/jsp/detail.jsp?infoid=1059840567100&type=CMS.STD>.

330 See III 4 Pricing of management buy-outs in this chapter, below, for more explanations.

331 The Measures for Administration of Acquisition of Listed Companies, Article 15, 31. See III 4 Pricing of management buy-outs in this chapter, below, for more discussion

explanation of the particular definition of management buy-outs, nor imports transparent regulations guiding the exercise of such transactions.[332] Moreover, although boards of directors and independent directors are under a duty to express on the appropriateness of an offer, and obliged to engage the services of investment banks and law firms to provide the equivalent of fair opinion and legal opinions respectively, the Measures do not specify what consequences would follow from the issuance of a false, misleading or otherwise dishonest opinion. Also, applying the Measures in practice may cause some confusion and uncertainties as some regulations permitting a management buy-out in the Measures are in contradiction with some prohibitions in several regulations enacted by the NPC and its Standing Committee, such as the Company Law, the Securities Law and the Commercial Banks Law of the PRC. For example, the Company Law formulates a threshold of investments by a company in other companies, which discourage Newco from purchasing shares in a target company.[333] Besides, the Measures do not provide principles for the purchaser to determine pricing in acquisition of shares in listed companies by agreement, but only specify the acquisition price in public offer. In fact, acquisitions of non-marketable shares by agreement prevail in the present management buy-outs. Lastly, even though the Measures remarkably play a core role in governing and guiding the management buy-outs of listed companies, it however can not apply to management buy-outs where the target is an unlisted company.

iii. Specialized rules for duty of information disclosure and duties imposed on independent directors

[332] Peng Zhenming & Zhou Zifan, “Legal Analysis of Management Buy-outs”, Science of Law, 2003, vol.3. at 112.

[333] This prohibition and more examples will be discussed in this Chapter, below.

In order to avoid self-interested transactions and protect the rights and interests of the target's shareholders, creditors and the target's assets, the duty of information disclosure is stressed by CSRC in the Administrative Rules of Information Disclosure on Change of Shareholding in Listed Companies[334] and four guidelines composed of the Contents and Formats for Information Disclosures by Companies that Offer Securities to the Public Guidelines (No. 15 Guidelines): Change of Shareholdings in Listed Companies Report;[335] the Contents and Formats for Information Disclosures by Companies that Offer Securities to the Public Guidelines (No. 16 Guidelines): Listed Company Takeover Report;[336] the Contents and Formats for Information Disclosures by Companies that Offer Securities to the Public Guidelines (No. 17 Guidelines): Takeover by Offer Report;[337] and the Contents and Formats for Information Disclosures by Companies that Offer Securities to the Public Guidelines (No. 18 Guidelines): Board of Directors' Report.[338]

For the same purpose, CSRC issued the Guidelines for Introducing Independent Directors to the Board of Directors in Listed Companies[339] which is the first legislation to introduce the concept of the independent director and the Code of Corporate Governance for Listed Companies in China.[340]

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[334] It was issued by CSRC on September 28, 2002 which took effect on December 1, 2002. For Chinese full text please see online: < http://www.plusemi.com/3255.htm>.
[335] It was issued by CSRC on November 28 2002 and effective on December 1 2002. For Chinese text of the rules, see online: < http://www.csrc.gov.cn/cn/jsp/detail.jsp?infoid=1059840433100&type=CMS.STD>.
[336] It was issued by CSRC in November 2002 which came into effective in December that year. For Chinese text please see online: <http://www.csrc.gov.cn/cn/jsp/detail.jsp?infoid=1059840256100&type=CMS.STD>.
[337] It was issued by CSRC in November 2002 which came into effective in December that year. For Chinese text please see online: <http://www.csrc.gov.cn/cn/jsp/detail.jsp?infoid=1059840188100&type=CMS.STD>.
[338] It was issued by CSRC in November 2002 which came into effective in December that year. For Chinese text please see online: < http://www.csrc.gov.cn/cn/jsp/detail.jsp?infoid=1059839967100&type=CMS.STD >.
[339] It was issued by CSRC on 16 August 2001. For Chinese text see online: <http://www.csrc.gov.cn/en/jsp/detail.jsp?infoid=1059842062100&type=CMS.STD>.
[340] It was issued by CSRC on 7 January 2002. For Chinese full text see online: <http://www.csrc.gov.cn/en/jsp/detail.jsp?infoid=1060360880100&type=CMS.STD>.

iv. Special regulations on MBOs of State-owned Enterprises("SOE")

In a management buy-out, where a target is a state-owned enterprise, special regulations for state-owned companies will also apply.

In the first place, the development of the management buy-out transaction is one of the results of the reform of the state-owned assets management system.[341] However, there is a historical problem left over from China's old economic system that the status of the investor in state-owned enterprises was not recognized.[342] Where the target companies are state-owned in management buy-outs, it is arguable that the government may play dual roles of being the vendor and the rule-maker in such transactions. A question of unfairness may arise in this case. The establishment of SASAC[343] and the promulgation and implementation of Interim Regulations on Supervision and Management of State-owned Assets of Enterprises mean that the reform of the state-owned assets management system of China has achieved a significant breakthrough and entered a new stage. Because, firstly, according to it, the investors of state-owned assets are clarified separately into two categories, the State Council holding equity concerning lifelines of the national economy and national security and in enterprises engaged in the fields of important infrastructure and natural resources on behalf the State and

[341] The reform is not only a major task of deepening economic system reform, but also an important content of the improvement of socialist market economic system.
[342] See Chapter 3 II History and background of MBOs in China, above, for detailed discussion.
[343] See the website of the SASAC of the State Council , News Update "China State-owned Assets Management System Reform Entering New Stage" (22 May 2003), online: <http://www.sasac.gov.cn/eng/eng_qygg/eng_qygg_0001.htm> "SASAC is the organization authorized by the State Council to perform the responsibilities as the investor of the State-owned asset on behalf of the central government. Authorized by the State Council and in accordance with Corporate Law of People's Republic of China and related administrative regulations, SASAC act as the State-owned assets' investor to guide and push the reform and restructuring of the state-owned enterprises. Supervise the maintenance and appreciation of state assets value for those state-invested enterprises, reinforce the management of the state-owned assets, promote the establishment of modern enterprise system of the SOEs and improve enterprises' corporate governance, drive the strategic adjustment of the state-owned economic structure and layout."

the local people's governments holding equity concerning the remainder.[344] Secondly, the role of SASAC as the investor of the State-owned asset on behalf of the central government is separated from the functions of the government social and public management.

In the next place, an important notice pertaining to MBOs was later issued by the State Council, in November 2003, on Publication of Proposal by SASAC for Guidelines Governing Restructuring of State-owed Enterprises("the Proposal").[345] The Proposal envisions that the state will ultimately only retain an interest in a few industries and that SOEs will be subject to sweeping reorganization and sale. This loosening lent an impetus to the existing management in SOEs to acquire the SOEs' business which are already under their control and operation.

This proposal, as the first national set of rules for the restructuring of SOEs, is intended to address the large-scale loss of state-owned assets that occurred frequently in previous restructurings of SOEs. The Proposals also stress the urgency of increasing transparency in SOE sale transactions and acceleration and facilitation of the sale of state assets to either domestic or foreign private interests. According to the proposal, governance of restructuring of SOEs includes the following steps: government approval, general check of enterprise assets, financial auditing, assets evaluation, deal management, pricing management, payment collection management, protection of creditor's rights and protection of legal rights of employees. Transactions involving state-owned assets need approval from relevant

[344] The Interim Regulations on Supervision and Management of State-owned Assets of Enterprises, Article 4, 5 and 6.
[345] State Council, 30 November 30, 2003, O'Melveny & Myers LLP, China Law & Policy Digest (30 December 2003), "Notice by State Council on Publication of Proposal by state-owned Assets Supervision and Administration Commission for Guidelines Governing Restructuring of State-owed Enterprises". For Chinese text please see online: < http://www.sasac.gov.cn/qygg/qygg_0033.htm >.

governmental agencies, and creditors and workers that are affected and shall be conducted by way of competitive bidding in the open market for ownership transfer in the case of unlisted companies.

Importantly, the proposal addresses the hot topic of management buy-outs in the restructuring of SOEs. In all respects, private interests are encouraged to take a more active role in the modernization of the public sector,[346] but transactions that are grossly undervalued or that undermine social stability are to be suspended in accordance with the Proposals.[347] The government is keen to minimize the abuses, in particular in the context of management buy-outs which periodically make news headlines.[348] For instance, the Proposal states that self-interested purchases are strictly prohibited. It requires that managers buying the state-owned assets of their own companies are banned form participating in key decisions, such as determination of price, and managers are not permitted to finance the purchase of state-owned assets through either loans made by SOEs, or through loans secured by state-owned assets, which is also in line with the General Rule of Loan. Besides, managements who are responsible for the decrease of the Company’s profit shall not be allowed to purchase the state-owned shares of such companies.[349]

[346] The Proposal by SASAC for Guidelines Governing Restructuring of State-owed Enterprises, Article 3(1).

[347] The Proposal by SASAC for Guidelines Governing Restructuring of State-owed Enterprises, Article 1, 3(2). According to official statistics, the average price reached by state-owned assets in non-listed companies transferred through equity exchanges is 10% above their appraisal value, whereas the average price of state-owned assets negotiated privately is about 30% below their appraisal value. See “Opinion on Governing the Restructuring of SOEs Delivered by the Principal Officers of SASAC” (December 18 2003), China Securities Journal, online: < http://www.cs.com.cn/>.

[348] For instance, the sale of State-owned Zhengzhou Yutong Bus Co., Ltd to a group of managers in 2001. For detail discussion on this case, see II types of present management buy-outs in China in this chapter, below.

[349] The Proposal by SASAC for Guidelines Governing Restructuring of State-owed Enterprises, Article 10.

However, though principal requirements for management buy-outs are set out in the Proposal, detailed rules will still be issued in the future.

In the third place, on February 1 2004, the SASAC and the Ministry of Finance's Tentative Procedures of Administration of the Assignment of Enterprise State-owned Assets and Equity ("the Tentative Procedures") came into effect, which marks another legal step in China's effort to reform the state sector of the economy.

The Tentative Procedures state that transfers of state-owned assets must be conducted either through auction, competitive bidding or agreement. The Tentative Procedures go one step further than the Proposal and establish a compulsory regime by which any transfer of state-owned assets in enterprises should be conducted through qualified equity exchanges.[350] Admittedly, this move to further regulate the market has been discussed for some time and is already reflected in some notable local regulations.[351] With the enactment of the Tentative Procedures, equity exchanges are promoted as a new platform for state-owned asset transactions.

Thus, it shall be borne in mind that management buy-outs usually regarding the acquisitions of shares and assets in state-owned companies shall not contravene the above legislation issued by SASAC for the protection of the state-owned assets.

[350] Equity exchanges are established and sponsored by local governments to act as equity and asset transaction platforms and to provide a wide range of services to facilitate transactions.

[351] A number of local regulations have recently been enacted that govern the establishment and management of equity exchanges. Local regulations have been promulgated in Shanghai, Beijing, Tianjin, Shenzhen, Chongqing, Guangzhou and Shandong province.

C. Regional regulations regarding MBOs

According to the 1982 constitution, the People's Congress and their Standing Committees of provinces, autonomous regions and municipalities directly under the central government can adopt local regulations that do not contravene the Constitution, state laws and regulations.

Regional regulations play an important role in regulating management buy-outs. In practice they supplement the national law and regulations which are usually only general and broad principles. To some extent, they fill the legal loophole left temporarily by the national legislations. The Opinions on Holding of Shares in SOEs by Management issued by local governments in Shanghai, Shenzhen, Beijing and Hubei governing management buy-outs are such examples.[352]

Overall, The above three categories of laws comprise the majority of Chinese law on MBOs.

II. Types of present management buy-outs in China

Before discussing the legal issues of the recent MBO transactions in China, it is important to review several typical MBO cases and demonstrate empirical types of MBOs in four categories(Figure 5). The reasons for different structures of MBOs below will be discussed later in this Chapter.

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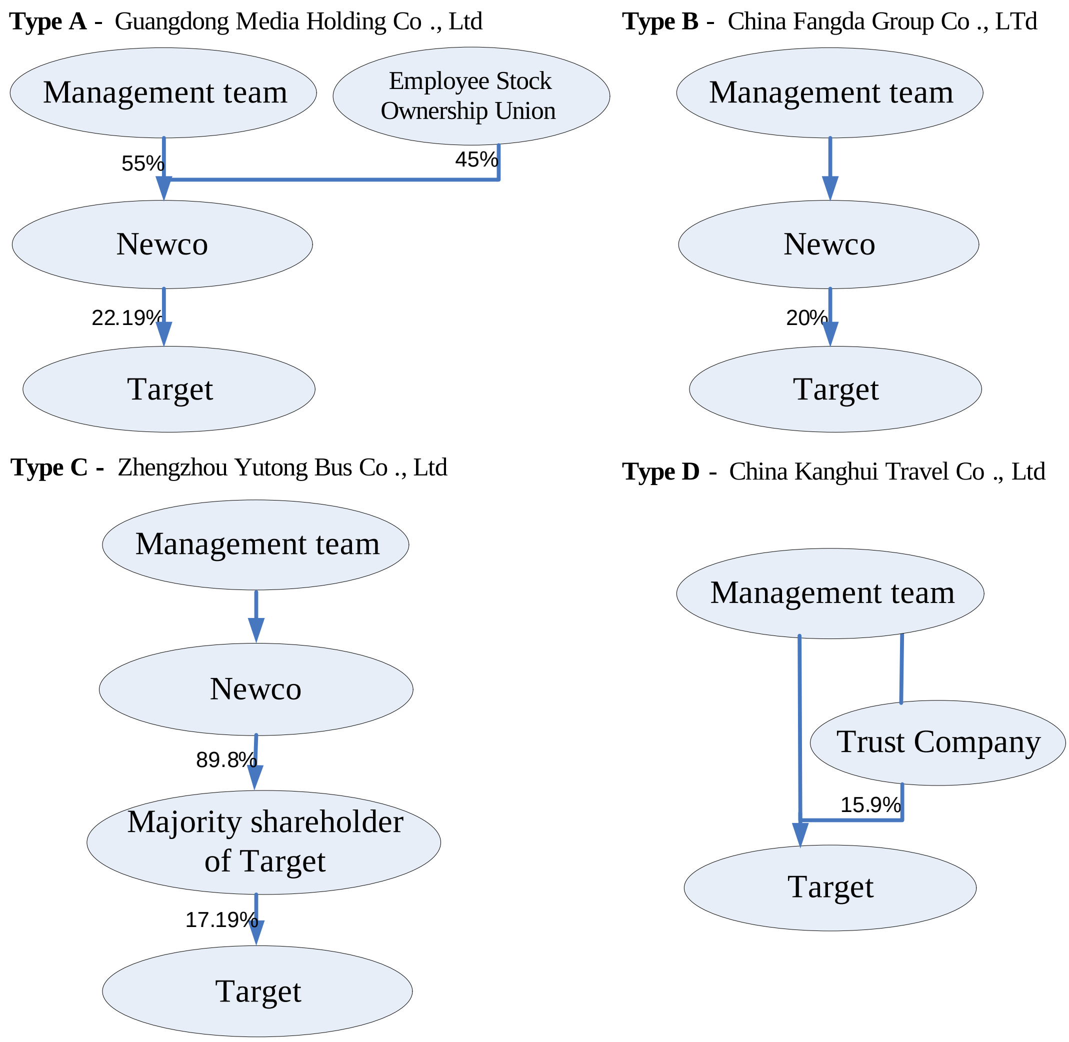
[352] See "Opinion on Holding of Shares in SOEs by Management" issued by Beijing local government on June 20 2001. For Chinese full text, see online: <http://chanye.cashq.ac.cn/html/10/43330.htm>. See also "Opinion on Holding of Shares in SOEs by Management" issued by Shenzhen local government on January 17 2002. For Chinese full text, see online:<http://www.eoechina.com.cn/news/news_single_show.asp?n_id=1092>.

Figure 5: Four Prevailing Types of Management Buy -outs in China



In the first place, management team may incorporate a Newco with the Employee Stock Ownership Union established by a number of employees to procure the shares of the target. The example of management buy-outs of Guangdong Media Holding Co., Ltd.[353] is illustrated as Type A in Figure 5. In the second place, a Newco is incorporated by management team solely to acquire an equity interest in their business of the target, for instance, management buy-outs of China Fangda Group Co., Ltd.[354] which is demonstrated as Type B in Figure 5. In the third place, management team set up a Newco to acquire a controlling stake of the majority shareholder of the target. This method proved to be successful in management

[353] See this company on <http://www.midea.com.cn/english/contactus/contact.jsp>.
[354] See this company on <http://www.fangda.com/main.asp>.

buy-outs of Zhengzhou Yutong Bus Co., Ltd[355] according to Type C in Figure 5. Finally, a novel way by which a trust company is entrusted by management team China Kanghui Travel Co., Ltd.[356] to hold the shares of the China Kanghui Travel Co., Ltd is indicated by Type D in Figure 5.

III. Legal problems arising in current MBOs

1. Who can be the purchaser?

A. Can an individual directly acquire shares or assets of the target in management buy-outs?

In line with the Measures, the purchaser in the acquisition is described as the person who obtains actual control of the target company through certain share transfer activities or by other lawful means.[357] However, it is not clear whether incorporated entities, organizations and individuals are all within the scope of the purchaser in an acquisition. In the same way, the Chinese Securities Law doesn't provide explicit rules either.

The Tentative Procedures apply to activities whereby state-owned assets supervision and administration authorities and enterprises holding state-owned capital assign, with consideration, the enterprise state-owned assets and equity held by them to domestic or foreign legal persons, individuals or other organizations.[358] Accordingly, individuals are included as assignees. However, the following separate rules impede management individuals

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355 See this company on <http://www.yutong.com/EN/about/qygk.asp>.
356 See this company on <http://www.cct2000.com.cn/default.asp>.
357 The Measures for Administration of the Acquisition of Listed Companies, Article 2.
358 The Tentative Procedures, Article 2.

purchasing directly shares and assets of the target company in practice.[359]

Firstly, In the light of the Interim Measures for Administration of Share Issuing and Dealing, an individual is not allowed to hold more than 0.5% of the ordinary shares issued to the public of a listed company.[360] Thus, individuals are obviously deprived of the capacity of the theoretical purchaser of marketable shares in management buy-outs of a listed company accordingly. However, another regulation imposes disclosure obligations on an investor including a natural person who starts to directly hold[361] or control[362] more than 5% of the shares issued by a listed company.[363] A discrepancy in the two statutes causes a great confusion as to the extent to which an individual can directly hold the shares in a listed company.

Secondly, it is explicitly stipulated that directors and the managers shall not operate their own, or operate for others, the same category of business as the company they are serving or, engage in activities which damage the interests of the company. If a director or the manager engages in such business or activities, the incomes derived therefrom shall belong to the company.[364] In China, following the management buy-outs, management team usually would

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359 Zhu Wuxiang (School of Economics and Management Tsinghua University), "Comparative Study on Management Buy-outs"(2003), Shanghai Stock Exchange, online: < http://www.sse.com.cn/cs/zhs/xxfw/jysjs/sseResearch/2003-2/20032d.pdf>.

360 The Interim Measures for Administration of Share Issuing and Dealing, Article 46.

361 A share holder refers to a natural person, legal entity or other organization that is registered in the shareholder register of a listed company.

362 A share controller refers to a natural person, legal entity or other organization that, without registering the shares under his or her name, controls the shares of a listed company held by other legal means, such as equity control in an incorporated entity, agreement or other arrangement etc, other than share assignment in the stock exchanges.

363 The Administrative Rules of Information Disclosure on Change of Shareholding in Listed Companies, Article 7, 8 and 15.

364 The Company Law of PRC, Article 61.

not only hold a post in the Newco they incorporated but also retain their post in the target company which is already under their successful operation. In this case, there is a likelihood of contravening the relevant regulations.

Finally, in practice, where the acquirer in a management buy-out is merely composed of management individuals, financing provided by them out of their savings is unlikely to be sufficient to finance the management buy-out. The Company Law of the PRC states that directors and the managers shall declare the number of shares held by them in the company, and shall not transfer such shares during their term of office.[365] However, only shares which are transferable according to law can be pledged.[366] As a result, management team members who hold shares of the target company could not get financing that required a pledge of such shares. It can be predicted that such restrictions on the transfer and pledge of shares will contribute to a rise in the acquisition cost in management buy-outs.

As a result, currently, a management individual doesn't have the capacity of acting as the direct purchaser in management buy-outs according to above statutes. Also practically, it is very difficult for the management individual to purchase the shares or the assets of the target to complete the management buy-outs. Management have to seek another ways to achieve their purpose for MBO.

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[365] The Company Law of PRC, Article 147.
[366] The Guaranty Law of PRC, Article 75.

B. Can a Special Purpose Vehicle, Newco be incorporated to acquire shares or assets of the target in management buy-outs?

In UK, Newco is commonly a limited company which management and outside financiers will set up and in which they will subscribe for shares whilst the managers have insufficient funds to buy the company outright and therefore need a third party to finance the deal. It is Newco which will purchase either the shares in the company or the business and assets of the company being sold by the vendor. And normally management will hold a majority or a substantial minority of the equity in the new company.

Currently, most management buy-outs in China have been achieved where a Newco is set up by the management team to purchase either the shares in the company or the business and assets of the company being sold by the vendor. The management buy-out of China Fangda Group Co., Ltd. is a representative example in this situation, which is demonstrated as Type B in Figure 5. And Type C in Figure 5 shows a Newco is incorporated to purchase either the shares or the business and assets of the majority shareholder of the target company. Also, in a Type A situation a Newco is established by management and Employee Stock Ownership Union. However, management buy-out through a Special Purpose Vehicle is problematic in China for certain reasons.

On one hand, in conformity with the Company Law of the PRC, in the event that a company, other than an investment company or a holding company as specified by the State Council of the PRC, invests in other limited liability companies or joint stock companies (also referred to as company limited by shares), the aggregated amount of such investments shall not exceed fifty percent of the net assets of the company. There is only one exemption to this restriction of fifty percentages if an increase of investment is out of the profit of the company.[367] However, Newco is not recognized as an investment company or a holding company by law, and it is virtually impossible for the newly-established Newco to maintain its net assets double of the capital to be raised to purchase the shares of the target. Many scholars are skeptical of this impediment and propose it shall be discarded, but before the amendment to the Company Law, a threat of violation arising from this method utilized in management buy-outs in China must be scrutinized.

On the other hand, a company is not capable of being established by a single management member to carry on a management buy-out in accordance with the Company Law of PRC, because companies incorporated within the territory of the People's Republic of China can take two forms[368], one is limited liability company[369], the other is joint stock company[370], a limited liability company shall be jointly invested in and incorporated by not less than two and not more than fifty shareholders.[371] Only state-authorized investment institutions or departments authorized by the State may independently invest in and establish wholly State-owned limited liability companies.[372] To incorporate a joint stock company, there shall

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[367] The Company Law of the PRC, Article 12.
[368] The Company Law of the PRC, Article 2
[369] The Company Law of the PRC, Article 3, in the case of a limited liability company, shareholders shall assume liability towards the company to the extent of their respective capital contributions, and the company shall be liable for its debts to the extent of all its assets.
[370] The Company Law of the PRC, Article 3, in the case of a joint stock company, its total capital shall be divided into equal shares, shareholders shall assume liability towards the company to the extent of their respective shareholdings, and the company shall be liable for its debts to the extent of all its assets.
[371] The Company Law of the PRC, Article 20.
[372] *Ibid.*

be five or more sponsors, of which more than half must have their domicile within the territory of the People's Republic of China.[373] In practice, as the incorporation of a joint stock company must be subject to the complicated procedures of examination and approval from the relevant governing institute of the PRC, a limited liability company is commonly set up for the purpose of management buy-outs.[374]

In contrast, in UK any type of company is capable of being incorporated with a single member. The decision of the House of Lords at the end of the nineteenth century in *Salomon v Salomon* & *Co*[375] established the legality of the "one-man" company as it in effect allowed the incorporation of a company with a single member and other six being nominees for him. This judicial decision preceded by nearly a century the adoption of EC Directive 89/667[376], which requires private companies formally to be capable of being formed with a single member.[377] And the one-person company is now expressly recognized by English Law. Although in China a single management could circumvent two-member threshold by a device such as having a company incorporated by him and his nominees as the other member, legislation permitting incorporation of a company with a single member should be considered in China.[378]

Also, management team shall bear in mind the threshold of the number of shareholders where more than 50 management team members and institutional investors intend to be involved in

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373 The Company Law of PRC, Article 75.
374 The Company Law of PRC, Article 9.
375 *Salomon v Salomon* & *Co* [1897] A. C. 22, HL. In this case, the House of Lord held that the company has been validly formed since the Act merely required seven members holding as least one share each.
376 [1989] O. J. L395/40. See s.1(3A). For public companies, the minimum requirement remains at present two members (s.1(1)), through the CLR (Formation, para. 2.11) has proposed that any type of company should be capable of formation with a single member.
377 Paul L. Davies, *supra* note 56 at 5, 29.
378 Wang Tianhong, *Comparative Study on Corporation with One Member* (China: Law Press China, 2003) at 377.

the management buy-outs.[379] And in the management buy-outs where a Newco is incorporated to purchase shares or assets of the target company, not only income tax shall be paid by Newco on the income derived from its production and business operations,[380] individual income tax shall be also imposed on management's income from share dividends and bonuses.[381]

Thus, the current legislation throws obstruction in the way of the development of management buy-outs activities in China.

C. Can Employee Stock Ownership Union be established to acquire shares or assets of the target with management of the target in management buy-outs?

i. Impediment under Chinese Law

In order to circumvent the 50-member limit prescribed by the Company Law, in the earlier case of management buy-outs of Guangdong Media Holding Co., Ltd.(Type A in Figure 5) where more than 50 management team members were involved, the chairman of the board of directors and Employee Stock Ownership Union of the target company incorporated a limited liability company to purchase the shares of the target company. In this case, the Employee Stock Ownership Union is recognized as one member. In the same way, management buy-outs are implemented through the incorporation of Newco by Employee Stock Ownership Union

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[379] The Company Law of PRC, Article 20.

[380] The Income Tax Law of the PRC for Enterprises(effective on January 1, 1994), Article 5. For Chinese text please see online: <http://www.wetdz.gov.cn/cn/policy/pop.asp?id=57>.

[381] The Individual Income Tax Law of the PRC, Article 2. It was adopted at the Third Session of the Fifth National People's Congress on September 10, 1980 and revised on October 31 1993 and August 30 1999. For Chinese full text please see online: < http://www.sdinfo.net.cn/fagui/content/ba010.htm>.

of the target companies including China Stone Group Co., Ltd,[382] Dazhong Jiaotong Group Co. Ltd. However, there is a dispute about whether Employee Stock Ownership Union is capable of participating in the management buy-out transactions.

In line with the purpose of the 15th National congress of the communist party of China held in September 1997, Employee Stock Ownership Union has been considerably generated as a provisional trust organization during the process of the restructuring of Chinese enterprises so as to clarify the ownership of the state-owned or collective-owned enterprise.[383] Since there is no unified code governing Employee Stock Ownership Union, and no separate rules can be found in the Company Law of PRC regarding Employee Stock Ownership Union's capacity of being a shareholder of a company, some provisional rules on Employee Stock Ownership Union are provided by the local governments of Beijing, Shanghai, Shenzhen, that where individual employees intend to subscribe for shares of a company, a union shall be set up and registered as a social organization to hold all shares subscribed by employees.[384]

However, since the Regulations on Registration Administration of Private Non-enterprise Units[385], Employee Stock Ownership Union shall be established as a social organization by individual employees using non-state-owned assets and conduct not-for-profit social service activities.[386] As no private non-enterprise unit shall conduct business activities for profit,

382 See this group on <http://www.stone-group.com.cn/>
383 Wang wei & Li shuguang, *MBO: Managers Become Shareholders*, (Beijing: China Renmin University Press, 1999), at 100.
384 *Ibid.* at 102.
385 This regulation was promulgated by the State Council on Oct 25 1998 and come into effective on the same day. For the full Chinese text please see online: <http://www.cec-ceda.org.cn/shangqxd/stfg/sttl1.htm>.
386 The Regulations on Registration Administration of Private Non-enterprise Units, Article 2.

Employee Stock Ownership Union is forbidden to be engaged in management buy-out transactions.[387] In accordance, the Ministry of Civil Affairs of PRC suspended the registration of Employee Stock Ownership Union for social organization since 1999. Subsequently, CSRC concluded that Employee Stock Ownership Union is not a legal entity but only an internal organization of a company, so it is ineligible to be the shareholder of a listed company.[388]

On the other hand, in such management buy-outs, the actual scope of the purchasers in regard with the management buy-out is expanded to the whole employees but not certainly limited to the management team only. This may give rise to an unclear ownership of a target company which contradicts the original purpose to clarify the ownership during the restructuring of the target company.

As a result, the deterrent regulations and policies above make the equity participations of the Union of Shareholding Employee unfeasible in management buy-outs. However, this method used in earlier management buy-outs is akin to the variant form of management buy-outs in UK, the Employee Stock Ownership Plan ("ESOP").

ii. Background and concept of ESOP in U.K.

In UK, the participants in management buy-outs may consist of a select team of the most senior management, or it may include a group of all the employees of the business concerned. An ESOP can be used to give employees a stake in a management buy-out**,** especially when

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[387] The Regulations on Registration Administration of Private Non-enterprise Units, Article 4.

[388] For Chinese text of "A reply regarding whether the Union of Shareholding Employees is capable of being a shareholder of a listed company" (December 11 2000) please see China Securities Regulation Commission, online : <http://www.csrc.gov.cn/cn/jsp/detail.jsp?infoid=1060090957100&type=CMS.STD>.

constraints of confidentiality and time may not allow involving the employees directly, with a subsequent allocation at the buy-out price. The first and best example was the massive buy-out of the National Freight Corporation by 26,000 of its managers and employees in 1981.[389] It was this deal which first introduced the concept of the management buy-out to the public at large. Also, it proved successful as a means of denationalizing a company in the public sector that this pattern was used again for the purchase of the Victaulic Company, a former subsidiary of the British Steel Corporation, by 561 out of its 880 employees[390]. Later in 1986, the government accepted a management consortium bid of £100m for its Vickers warship yard, in which were offered not only to employees and their relatives, but also to residents in the area around the yards.[391]

Section 309 of the Companies Act 1985 places a duty on company directors to have regard to the interests of their company’s employees as well as to the interests of their shareholders. Also Section 719 of the 1985 Companies Act specifically empowers a company to provide for employees on the cessation or transfer of a business, notwithstanding that such provision may not be in the best interests of the shareholders.

And the tax environment for buy-outs was rendered progressively more favorable for employees. Since the Finance Act 1974, tax relief had been available for interest paid on loans to individuals to enable them to finance equity investments in close companies. Later, legislation was introduced in the Finance Act 1984 to extend the tax relief to

389 Lord Hanson, *supra* note 17 at para. 14.04.
390 *Ibid.*
391 *Ibid*.

employee-controlled companies where more than 50% of the equity is held by its employees.[392]

The Section 153 of CA 1985 was also amended by the section 132 of CA 1989, with effect from 1 April 1990, to permit companies to provide all forms of financial assistance for the purchase of their own shares, provided that such assistance is given in good faith in the interests of the company and for the purposes of an employees' share scheme. The trust, whether approved or not, is capable of being an employees' share scheme for CA purposes.

Finally, the concept of the ESOP was approved by the Government in the Finance Act 1989 (FA 1989).[393] A trust can now be a qualifying employee share ownership trust under the FA 1989, and there are now quite a number of ESOPS in place and considerable interest is being shown in them.

The extent and form of employee participation in the management buy-out is considered at an early stage. The practical difficulties of a full employee buy-out are numerous and such a scheme is appropriate only in a limited number of cases. In UK, employees can participate in the future success of their company in a number of ways from productivity bonuses, profit-related pay schemes, share option schemes (whether or not Inland Revenue approved), ESOPs to direct subscription for shares, possibly shortly after completion of the buy-out.[394]

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392 *Ibid.* at paras. 14.06-14.07.
393 William M. Rees. & Simon B. Jeffreys, "What is an ESOP", COMPLAW 1990, 11(7), 144-145.
394 Parliament has over the last dozen years introduced a statutory framework for the approval by the Inland Revenue of three types of employee share scheme: profit sharing schemes in the Finance Act 1978, savings-related share option schemes in the Finance Act 1980 and executive share option schemes in the Finance Act 1984. These

The central feature of an ESOP is that it is a discretionary trust in favour of employees, former employees and their immediate families, which can borrow money from the company or banks, then use that money to buy the company's shares, and feed those shares over a period of time to employees.[395] A common type of ESOP involves a dual trust structure: one trust, an employee benefit trust, acquires shares in a company, usually with financial assistance from that company; the second trust, an approved profit sharing scheme trust, acquires shares from the ESOP trust and distributes them to employees.[396]

Under ESOP arrangements, a block of shares can be held for employees generally and can be distributed to them over a period of years. This is often done through an Inland Revenue approved profit sharing scheme so that no tax charge arises. ESOP has a number of advantages[397], including being publicly acceptable, being a source of additional funding for the management buy-out, providing incentives for the employees who will have a close identification with the company and its performance and being tax efficient.

In this respect, an ESOP utilized in UK to give employees a stake in a management buy-out should be progressively introduced and legitimated in China.[398]

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three schemes concerned with the distribution of shares, can be used as part of an employee share ownership plan.

[395] Maureen J. Gorman. & M. Ellen Robb, "ESOPS for Multinationals", J.I.B.L. 1992, 7(8), 329-332.

[396] S.J.M. Evans, "Finance Bill Notes-Rollover Relief on Disposals to Qualifying Employee Share Ownership Trusts", B.T.R. 1990, 7, 206-213 (Legislative Comment).

[397] William M. Rees, *supra* note 393.

[398] Zhang Xianzhong, "Research on Legal Problems arising form Management Buy-outs of Listed Company", Shanghai Stock Exchange, online: < http://www.sse.com.cn/ps/zhs/sjs/xw/ssenews20030606.html>.

D. Can a Trust Investment Company be utilized to acquire shares or assets of the target in management buy-outs?

In an effort to overcome current hindrances to management buy-outs in China, a more desirable methodological approach (Type D in Figure 5) is employed. In this case, a trust company is entrusted by management team China Kanghui Travel Co., Ltd to hold the shares of the target company, China Kanghui Travel Co., Ltd. By 2003, 24 management buy-outs of listed companies have been accomplished through trusts buying corporate shares of listed companies.[399]

Now, trust and investment products have become very popular among Chinese investors. The promulgation of the Trust Law of PRC[400] represents an important step forward for China and its legal development. According to the Law, a trust refers to that the trustor, based on his faith in the trustee, vesting his property rights in the trustee, and allows the trustee to, according to the will of the trustor and in the name of the trustee, manage or dispose of such property for the interests of the beneficiary or any intended purposes.[401]

In accordance with the Administrative Rules on Trust and Investment Companies,[402] a trust company can manage or use the entrusted property by means of leasing, selling, lending,

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399 Lu Aibing, "MBO of An Hui Shui Li" (April 30 2004), Holly High Mergers and Acquisitions, Online: <http://www.hollyhigh.cn/hollylib/view.php?newsid=1151>.

400 It was promulgated by the Standing Committee of the National People's Congress, and come into effective on October 1 2001, full Chinese text please see online:< http://www.icbc.com.cn/detail.jsp?infoid=1071308921100&infotype=CMS.STD>.

401 The Trust Law of the PRC, Article 2.

402 It was promulgated by the People's Bank of China and take effective on July 18 2002, for Chinese text please see online: < http://www.fotic.com.cn/Knowledge/K_law/0206_005.htm>.

investing or interbank lending according to the terms of entrustment contracts,[403] and it can be engaged in considerably broad business.[404] A trust company's own capital in the account of owner's equity, which is permitted to be used according to relevant rules, can be deposited in banks or used in interbank lending, lease financing and investment.[405], Accordingly, making use of a trust company's own capital and entrusted property can legally and flexibly pave the way for diversifying approaches for management buy-outs in china.

In line with the regulation and from some successful experience which is illustrated by Figure 6, management buy-outs can be funded by both debt and equity provided by a trust company.

In the first instance, a trust is akin to a commercial bank where it provides loans to management or Newco to meet the capital demand in a management buy-out, it is the Newco which purchases the shares or assets of the target company.

In the second instance, a trust company purchases the shares or assets of the target company on its own name. In this situation, it is unnecessary to incorporate a Newco. According to the Provisional Rules on Entrusted Funds Management of Trust and Investment Companies[406], management team or their institutional investors vest their legitimately held funds in the trust company, the trust company is entrusted to purchase the shares or assets of the target company in its own name from the vendor with entrusted funds and their own funds. Under

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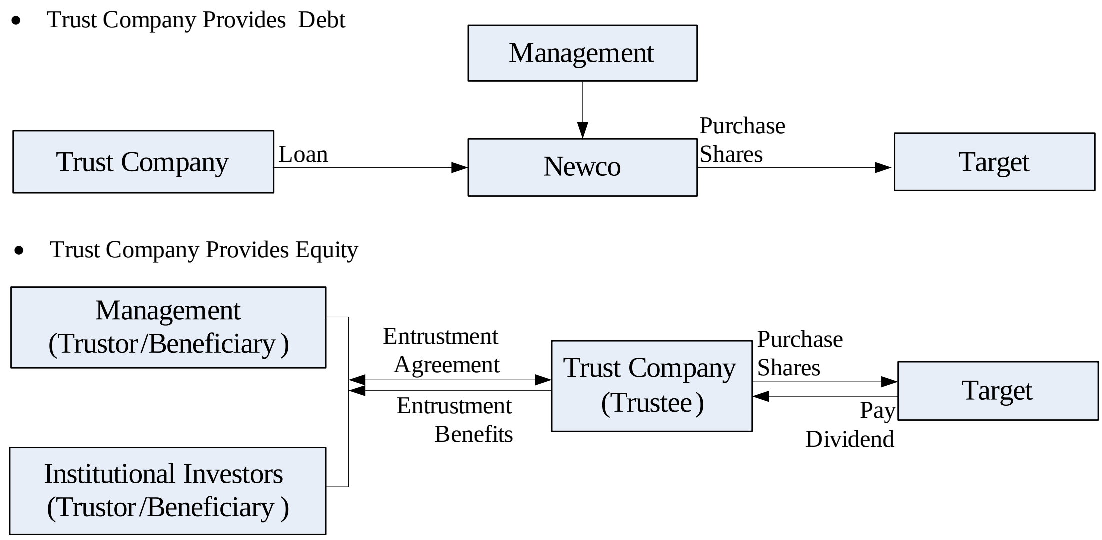
403 The Administrative Rules on Trust and Investment Companies of the PRC, Article 22.
404 The Administrative Rules on Trust and Investment Companies of the PRC, Article 20
405 The Administrative Rules on Trust and Investment Companies of the PRC, Article 24.
406 It was promulgated by the People's Bank of China and took effective on July 18 2002. For Chinese text please see online:< http://www.trustabc.com/read/readnews.asp?id=23822>.

an entrustment agreement between the trust company and management team together with their institutional investor, the acquired shares are in the possession of, disposed of and managed by the trust company in line with the trustors' will and aimed at benefiting the management team and their institutional investors.[407] Finally, the trust company returns the shares to management until gradual repayment by the management out of the benefits they obtained or under the entrustment agreement the trust company returns cash to management when shares are sold at an appropriate time.[408]

Figure 6: MBOs Funded by Trust Company



The advantage of inviting a trust company in the management buy-outs is multifold. First, it can obviate the restrictions stipulated by current statutes of China on the investment threshold by Newco in the shares of the target company and shareholder number threshold between 2 and 50. Second, it can surmount the current financing difficulties in management buy-outs caused by an insufficiency of financing resources in China. Third, in the management buy-outs where a Newco is incorporated to purchase shares or assets of the target company,

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407 The Provisional Rules on Entrusted Funds Management of Trust and Investment Companies, Article 2.

408 Guan Jianjun, "New Productions of Trust and Legal Analysis." Grandall Legal Group, online: <http://www.grandall.com.cn/bestweb/ghlaw/info/corpus/showcorpus.jsp?corpus_id=1011>.

not only income tax shall be paid by Newco on the income derived from its production and business operations,[409] individual income tax shall be also paid by the management as shareholders of the target on the income from share dividends and bonuses.[410] In the event that a trust company is entrusted by the management to purchase shares or assets of the target company with vested property, income taxes levied on the Newco can be avoided. Forth, trust property is differentiated from other properties owned by trustor not under the trust[411] and the property owned by the trustee[412] so that trust property is not considered as liquidated property when a trustor or a trustee is declared bankrupt. This plays a critical role on giving the parties involved in management buy-outs a feeling of security of their capital and properties. Finally, following a management buy-out, management's vested property is adequately protected because compulsory measures can not be taken over the vested property unless creditors have rights of repayment over the vested property before the establishment of a trust relationship.[413]

There is no exception to the fact that everything has its merits and demerits, although investing in management buy-outs through a trust is a convincing approach, management shall be discreet when introducing it to the deals. The Measures for the Administration of Disclosure of Shareholder Equity Changes of Listed Companies[414] reads that shareholder, share controller and person acting in concert obliged to disclose the information when the

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409 The Income Tax Law of the PRC for Enterprises(effective on January 1, 1994), Article 5. For Chinese text please see online: <http://www.wetdz.gov.cn/cn/policy/pop.asp?id=57>.

410 The Individual Income Tax Law of the PRC, Article 2. It was adopted at the Third Session of the Fifth National People's Congress on September 10, 1980 and revised on October 31 1993 and August 30 1999. For Chinese full text please see online: < http://www.sdinfo.net.cn/fagui/content/ba010.htm>.

411 The Trust Law of the PRC, Article 15.

412 The Trust Law of the PRC, Article 16.

413 The Trust Law of the PRC, Article 17.

414 This measure was promulgated by China Securities Regulatory Commission and come into force on December 1 2002. For Chinese text please see online: < http://www.csrc.gov.cn/cn/jsp/detail.jsp?infoid=1059812607100&type=CMS.STD>.

number of shares of a listed company held or controlled by it is changed or may be changed and the change has reached the prescribed ratio[415], and the information disclosed by them shall be authentic, accurate, complete, and without false records, misleading statements or major omissions.[416] Apparently, in the context of a management buy-out of listed company, a trust company falls within the share controller and person acting in concert,[417] so relevant information shall be disclosed. But on the other side, the trustee shall have the obligation to keep confidential the information relating to the trustor and the beneficiary of the trust and the situation of entrustment affairs, unless stipulated otherwise by laws, administrative regulations or the entrustment contract.[418] As the Measures for the Administration of Disclosure of Shareholder Equity Changes of Listed Companies is not at a high level of law or administrative regulation, the obligation of information disclosure is disputed. To take advantage of trust in management buy-outs' practice, it is necessary to remove inconsistencies of the statutes in this respect.

2. Financing of MBOs

Unless the target business is relatively small and can be financed directly by individuals, most buy-out teams can only provide a small proportion of the necessary funding. In UK, virtually all MBOs are financed with a combination of debt finance, mezzanine finance and equity. As a result, management are likely to look to a number of funding sources including debt usually

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[415] Measures for the Administration of Disclosure of Shareholder Equity Changes of Listed Companies, Article 6.
[416] Measures for the Administration of Disclosure of Shareholder Equity Changes of Listed Companies, Article 3.
[417] Measures for the Administration of Disclosure of Shareholder Equity Changes of Listed Companies, Article 9. "Person acting in concert refer to two or more natural persons, legal persons or other organizations that make the same declaration of will when exercising their voting power of the listed company to expand the ratio of shares of that listed company controlled by them or to strengthen their control over the listed company by legal means such as agreement, cooperation, association relationship, etc."
[418] The Trust Law of the PRC, Article 33, and The Administrative Rules on Trust and Investment Companies of the PRC, Article 34.

provided by specialized acquisition finance units of UK clearing banks or investment banks, and equity provided by venture capital companies or specialist buy-out funds.[419]

But financing the management buy-outs is a huge problem in China because of insufficient financing instruments in china and more importantly, numerous impediments in financing under Chinese law.

A. Current finance resources and relevant problems in China

The most commonly used sources of finance disclosed in the recently completed management buy-out transactions in China are obtained in the following ways. First, employees of the target company raise the funds and entrust the Employee Stock Ownership Union to purchase the shares of the target, as what I discussed above this finance resource is only attainable in earlier transactions but is banned under current law. Second, management may rely on their own funds to implement the transaction. But funds from the management individuals' remuneration are too finite. And where management is state functionary in a state-owned enterprise and his enormous financing in such a transaction obviously exceeds his lawful income, he may be ordered to explain the sources of his financing. If he cannot prove that the sources are legitimate, the part that exceeds his lawful income shall be regarded as illegal gains, and he shall be sentenced to imprisonment or criminal detention, and the part of financing that exceeds his lawful income shall be recovered.[420] Third, a great portion of the whole purchase price is financed by a term loan provided by commercial banks with a pledge of target company's shares by Newco. It obviously falls foul of the prohibition on the loan

[419] See Chapter 4 II 2 Types and sources of finance, above, for further discussion.
[420] The Criminal Law of the PRC, Article 395.

provided by commercial banks under the General Rule of loan which I will explain later. Fourth, some financing is provided from the capital of the target company. Such financing is illegal because it is incumbent upon directors and the managers of a target company not to misappropriate company funds or lend company funds to others.[421] Finally, in several cases, debt financing was provided by civilian individuals. But the rights and benefits of individuals who provide this kind of financing may not be protected as there are no explicit rules governing such activities under the Chinese Law. Also, this type of financing is expensive due to a normally higher interest rate than that of the loan provided by commercial banks.

To sum up, because of a threat of violating relevant Chinese laws, most information on the financial resources in above management buy-outs transactions are not disclosed or may be disclosed ambiguously.

B. Financing the management buy-outs under Chinese law.

i. Finance provided by commercial banks

Banks have established a strong presence in the financing of the larger UK management buy-outs. However, the most important role in financing management buy-outs played by UK commercial banks in either debt finance or equity finance is restricted under Chinese Law.

Firstly, financing by banks is restricted by the General Rule of Loan[422]. In regard with the General Rule of Loan, a borrower is prohibited to make equity capital investment with a loan

[421] The Company Law of the PRC, Article 60.
[422] It was issued by the People's bank of China on June 28, 1996. For Chinese text please see online: < http://www.jincao.com/fa/law09.29.htm>.

from a bank including subscription for registered capital, or increasing registered capital. Nor could a borrower invest in the securities or futures market with the loan obtained from the bank.[423]

In the same way, under the Commercial Banks Law of the PRC,[424] no commercial banks shall, within the People's Republic of China, engage in trust investment or securities business or invest in non-banking financial institutions or enterprises.[425] As well as under the Securities Law of the PRC, banks are prohibited from putting funds in the stock market.[426]

ii. Financing by way of public issue of bonds.

Unlike management buy-outs in UK, it is very difficult to finance management buy-outs through a public issue of bonds in China. Because only a joint stock limited company, a wholly state-owned company, and a limited liability company incorporated by two or more state-owned enterprises or by two or more other state-owned investment entities may issue company bonds for the purpose of raising funds for its production and operation.[427] And funds raised through the issue of company bonds must be used for the purpose approved by the examination and approval authorities and shall not be used to make up the losses of the company or for non-production expenditure.[428] Also, to issue company bonds, it is impossible for a Newco to meet such conditions required by law as for a joint stock company, i.e. the value of its net asset may not be lower than RMB 30,000,000; for a limited liability company,

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423 The General Rule of Loan, Article 71.
424 This law was promulgated by the Standing Committee of the National People's Congress and effective on July 1 1995. It was modified in 2003 and took effective on February 1 2004. For Chinese full text please see online: <http://www.pbc.gov.cn/detail.asp?col=310&ID=16>.
425 The Commercial Banks Law of the PRC., Article 43.
426 The Securities Law of the PRC. Article 133.
427 The Company Law of the PRC, Article 159.
428 The Company Law of the PRC, Article 161.

the value of its net asset may not be lower than RMB 60,000,000, the accumulated value of the bonds issued may not exceed forty percent of the value of the net assets of the company, the average distributable profits for the past three years shall be sufficient to pay the interest on the company bonds for one year.[429]

In addition, high yield bonds(junk bonds) can not be issued in China as the interest rate for the bonds shall not exceed the ceiling fixed by the State Council. Thus, it is illegal to finance management buy-outs through issuing company bonds.

iii. Finance provided by venture capital institutions, pension funds or insurance companies.

One feature which all the leading equity investors in management buy-outs in the UK have in common is that they are active players in the venture capital business.[430] This is in sharp contrast to the situation in China where the financing function of venture capitalists and institutional investors are at an early stage.

Also, mezzanine finance in UK is often made available by venture capital institutions and other specialists in the buy-out field including pension funds, insurance companies and other institutional investors. But capital providers including pension funds and life insurance funds in China are not permitted to engage in management buy-out financing. Under the Insurance Law of the PRC,[431] the employment of funds of an insurance company is limited to bank deposits, dealing in government and financial bonds and other forms of funds stipulated by

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[429] The Company Law of the PRC, Article 159

[430] Bryan de Caires, *supra* note 15 at 28.

[431] The Insurance Law of the People's Republic of China was promulgated by The Standing Committee of the National People's Congress on June 30, 1995, and was amended on October 28, 2002. For Chinese full text please see online: < http://www.people.com.cn/GB/shehui/43/20021029/853076.html>.

the State Council. The funds of an insurance company shall not be used for the establishment of organizations dealing in bonds or securities, and shall not be used for the establishment of enterprises other than those of insurance business.[432]

Like UK and other countries, it is necessary to expand the function of pension funds to investments in China including stocks, other than bank deposits and treasury bonds. This move is expected to make better use of the pension funds, infuse fresh blood into the capital market and bring lucrative business opportunities to fund managers. China's current pension system is formed by the basic social pooling pension, personal accounts, which are contributed to by the employees and employers together, and commercial insurance. So far, the funds put in personal accounts are expected to be released from constraints and the government should speed up relevant legislation.

iv. Two novel financing channels -- finance provided by trust investment companies and specialized management buy-out funds.

Currently, in order to overcome the financing difficulties to pave the way for the development of management buy-out activities in China, two financing innovations, specialized funds and trust companies, shall be introduced, although both of them have been subjected to legal limitations and risk under present Chinese law.

At present, trust and investment products have been in the lead in China's financial innovations. So far, 52 of China's trust and investment companies have obtained renewed

432 The Insurance Law of the PRC., Article 105.

registrations in line with China's current laws and regulations. The legality and advantage of financing by trust companies and how to provide debt and equity by a trust company have been already discussed above.

For specialist buy-out funds, although there is no investment funds law which makes them available for the financing of management buy-outs, the Trust Law of the PRC has implications for many aspects of structuring investments and financing within China. It applies to civil, business and charitable trusts and is intended to pave the way for a new investment funds law to further stimulate the Chinese economy. More importantly, its accessorial rules provide a feasibility of financing management buy-outs by specialist buy-out funds. First, a trust and investment company can be entrusted to operate investment funds businesses allowed by the laws or administrative regulations, and to engage in such businesses as a promoter of investment funds or a fund management company.[433] In addition, a trust and investment company can accept entrustment of two or more than two clients and manage, utilize and dispose of the entrusted funds collectively in an approach determined by the clients or by the trust and investment company on behalf of the clients.[434]

Accordingly, a specialist buy-out can be incorporated in the form of a trust and investment company. In practice, some specialist management buy-outs funds have been incorporated recently.[435] To finance a management buy-out, a specialist buy-out fund and management can incorporate a Newco to purchase the shares of the target company, and in this situation, a

[433] The Administrative Rules on Trust and Investment Companies of the PRC, Article 20.
[434] The Provisional Rules on Entrusted Funds Management of Trust and Investment Companies, Article 5.
[435] "Specialist management buy-outs funds in China", online: <http://www.winking.com.cn/MBO-9.htm>.

violation of the Company Law of the PRC which prescribes that the aggregated amount of investments by the Newco shall not exceed fifty percent of its net assets can be avoided. Alternatively, a specialist buy-out fund may play a role of institutional investor and acquire the shares or assets of the target company with the Newco, management will purchase back the shares at an appropriate time. Besides, specialist funds may provide a term loan, but loans between incorporations are strictly restricted, otherwise involved companies would be fined for violation.[436] Therefore, it is still necessary to provide a new investment funds law by Chinese government to govern the financing by investment funds.

3. Financial assistance

A. Background of financial assistance in UK

In many of the larger buy-outs, the management will of course be unable to subscribe sufficient share capital or borrow sufficient funds, at least on the strength of their own resources, to fund the purchase price. The only assets which can be made available as security, and the only cash flow which can service the necessary debt burden, are those of the target company itself.[437]

In UK, one substantial impediment to management buy-outs in the past was the inability of the management to provide assets of the target company as security in the raising of loans to support the acquisition. The only security available was personal guarantees or indemnities provided by the purchasing managers themselves, which was not an attractive proposition for

[436] The General Rule of Loan, Article 73.
[437] Lord Hanson, *supra* note 17 at para. 14.19.

either borrower or lender. However in the 1985 Companies Act the government changed the law so that, subject to certain conditions, the assets of a private company could be provided as security for an acquisition of its shares. This encouraged the development of the so-called “leveraged buy-out” whereby loans are secured on the assets of the target company concerned.[438]

B. Restrictions on financial assistance imposed by similar regulations in China.

The Company Law of the PRC stipulates that directors and the manager of the target company shall not misappropriate company funds or lend company funds to others.[439] And directors and the manager shall not use company assets as security for the personal debts of shareholders of the company or of other individuals.[440] Provided directors and the manager of the target company use company assets as security for the personal debts of shareholders of the company or of other individuals the contract of guaranty shall be declared null and void by the people’s courts.[441]

It can be noticed that the currently-generated Measures import the UK corporate law prohibition against financial assistance which is also a feature of the financing exercise in a management buy-out. It is stipulated that a purchaser without the capacity to actually perform is prohibited from making the acquisition of a listed company, and a company being acquired

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438 *Ibid*. at para. 14.12. See Chapter 4 IV Financial Assistance and MBO under Section 151 of the Company Act 1985, above, for more discussion on this topic.
439 The Company Law of the PRC, Article 60.
440 The Company Law of the PRC, Article 60.
441 The Judicial Interpretations of the Supreme Peoples Court on Implementing the Guaranty Law of the PRC, Article 4.

may not provide any kind of financial assistance to a purchaser.[442]

The latest Proposals also address that managers are not permitted to finance the purchase of state-owned assets through either loans made by SOEs, or through loans secured by state-owned assets. This prohibition is also in line with the General Rules of Loan.

The most common type of financial assistance is giving security over the assets of the target or its subsidiaries in the form of guarantees, charges and mortgages to support loans to Newco. Other common forms of financial assistance are making loans, waiving loans, giving credit or selling assets on deferred terms or a gift. However, the existing statutes in China relating to restrictions on financial assistance are too broad and it is only applicable to the acquisition of listed company. After looking at the prohibition on financial assistance in the relevant UK Law, for the sake of protecting the target's assets and creditors of the target, a general prohibition such as Section 151 and a clear description of "financial assistance" as Section 152(a) should be furnished in China's Statute, followed by several exemptions to the general prohibition based on China's practice to facilitate the financing in management buy-outs and China's economic reform.

4. Pricing of management buy-outs

In China, there has been a certain amount of discussion as to whether, in existing management buy-outs, the target companies are acquired at a reasonable and fair price, in terms of protecting state-owned assets and minority ordinary share holders. In UK, usually, appropriate

[442] The Measures for Administration of Acquisition of Listed Companies, Article 7.

price earnings ratios are used and the net assets base is considered in such transactions;[443] due to the different corporate mechanism in China, appropriate valuation method shall be projected and scrutinized to service the management buy-outs under Chinese law.

A. target companies in acquisitions

In light of the different ownership and legal status, the objects acquirable in China are categorized by state-owned shares and corporate shares in listed companies, marketable shares in listed companies, unlisted state-owned enterprises, unlisted collectively-owned or private enterprise, unlisted foreign-invested enterprise. Currently, State-owned shares and corporate shares possess a majority proportion of targets to be acquired in management buy-out transactions in China.

In China, shares in listed companies are of two types, shares that can be directly traded on stock markets(generally known as marketable shares) and shares that can not be circulated on stock markets(generally known as non-marketable shares). Holders of marketable shares include individual investors and institutional investors. Non-marketable shares include state-owned shares held by institutions authorized by the State, corporate shares held by corporate legal entities or other institutional legal entities and a small quantity of non-marketable shares held by individuals. According to the data provided by the Shanghai Stock Exchange[444] in July 2001, the state-owned shares and corporate shares in listed

[443] See Chapter 4 II 1 Valuation and price, above for more discussion on this topic.
[444] The State Council decided to use Shanghai and Shenzhen to experiment in the trading of shares. The Shanghai Stock Exchange was established in 1984 and was officially opened on December 19 1990.

companies account for 62.95% of total shares in listed companies.[445]

B. Current pricing measures and problems

The position for a listed company in UK is very different from those in China, as the market itself sets a value on the individual shares and this sets a market capitalization for the company as a whole. Due to the lack of marketability, it is difficult to apply the price of marketable shares in secondary stock markets to price the state-owned shares and corporate shares in listed company of China in management buy-out transactions. Also, there is no market mechanism setting a price for unlisted collectively-owned or private enterprises.

For current acquisition of non-marketable state-owned and corporate shares, acquisition by agreement, not the acquisition by public offer normally used in the securities market, is adopted in current China's management buy-out transactions. These non-marketable shares are held by government departments or their authorized corporations, so governmental interference is irrevocably involved in pricing negotiation, which may result in unfairness.

As there is no explicit pricing rule for acquisition by agreement under Chinese law, price negotiation in practice is normally based on net assets of the target. For acquisition of corporate shares, the usual practice is that price is negotiated at a discount to the net assets valuation of the target. For acquisition of state-owned shares, price in negotiation is simply

[445] China Securities Regulatory Commission, "State-owned Shares and Corporate Shares?" online: <http://www.csrc.gov.cn/cn/jsp/detail.jsp?infoid=1062563912100&type=CMS.STD>.

based on the policy in 1997 by SASAC,[446] which set out a threshold that the price of state-owned shares transfer shall not be less than the net assets value of the target.

However when a target company is a listed company, the whole shares of the listed company consist of not only the non-marketable shares but the marketable shares. As a result of a dilution of profits generated by marketable shares subscribed by the marketable shareholders at a premium, the net assets value of the non-marketable shares in listed company will increase. It is not equal and fair to the holder of marketable shares in a listed company as they are not capable of purchasing non-marketable shares at a price less than the net asset value or slightly higher than net asset value. But such shares at such prices can be easily acquired by the management.

Moreover, while the price of state-owned shares in a management buy-out is not less than the net asset value of the target, a loss of state-owned assets still can not be avoided, as it can be argued that the value of the target is simply the valuation of the assets less any liabilities that it has in its balance sheet. It is the current net asset which only provides historical profits with an unknown future profits generated by the target. Furthermore, there is a loss of the state-owned assets of the target even where a price negotiated is higher than the net asset value of the state-owned shares, because a large quantity of intangible properties as goodwill and intellectual property may contribute significantly for the future profits of the target, but due to the limitation of current accounting mechanism, they are not included in the net assets

[446] Chen Mingjian, "Transform of State-owned Assets", SASAC, online: <http://www.sasac.gov.cn/gzyj/200304/0414-4.htm>.

of the target. Additionally, the market value of an asset may be materially different to the value shown in the balance sheet, where a price negotiated is less than the net assets value of the state-owned targets, a loss of state-owned properties occurs.[447]

Some people hold that the measures adopted in UK should be introduced to the pricing in China's management buy-outs, as appropriate price earnings ratios are used, the net asset value of the company can be used for setting a base price level, and Discounted Cash Flow is considered in certain cases. However, in my point of view, simple reliance on net asset valuation is not an appropriate measure of pricing in China's management buy-outs, and the popular measures employed in UK may not be suitable for the current economic system of China during reform, which is substantially different from other countries'. Although, how to make an applicable pricing mechanism in China's management buy-outs shall be left to the Chinese economists, it is necessary to improve the Chinese law in this respect, introduce the independent financial advisors' role, develop and guide the business of professional institutions and invite purchasers in competition with the management for acquisition of the target.

C. Pricing legislation and improvement

i. Introducing pricing in acquisition of shares in listed companies by public offer

The Measures provide principles for the purchaser to determine the acquisition price in a public offer. For instance, in the case of listed and traded shares, the acquisition price for

[447] Zhu Wuxiang, (School of Economics and Management Tsinghua University) "The Rationalization of the Pricing" (September 24, 2003), Xinhua News, online:<http://news.xinhuanet.com/fortune/2003-09/24/content_1098027.htm>.

shares of the same kind shall not be less than the highest price paid by the purchaser for the said kind of shares of the company within 6 months prior to the date of publication of the declaratory announcement or 90 percent of the arithmetic mean of the daily weighted average price of the same kind of listed and traded shares of the company to be acquired within 30 trading days prior to the date of publication of the declaratory announcement, whichever is higher.[448]

In the case of unlisted shares, the acquisition price for shares of the same kind shall not be less than the highest price paid by the purchaser for the same kind of unlisted shares within 6 months prior to the date of the declaratory announcement or the net asset value per share of the target company which is audited in the last announcement, whichever is the higher.[449]

Under special circumstances, if it is necessary to change the implementation of the price determination principle described above, the purchaser shall seek the prior approval of the CSRC. If the price proposed by the purchaser is obviously unfair, the CSRC may demands the purchaser to make readjustment.[450]

The purpose of the above principles is to protect the minority shareholders of the target from any loss and damage caused by offering a lower price by the purchaser in a public offer with an agreement prior to the public offer between the majority shareholders and the purchaser on a higher price and more preferential conditions. For pricing in acquisition of shares in a listed

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448 The Measures for Administration of Acquisition of Listed Companies, Article 34.
449 The Measures for Administration of Acquisition of Listed Companies, Article 34.
450 The Measures for Administration of Acquisition of Listed Companies, Article 34.

company by agreement, principles for the purchaser to determine the acquisition price in a public offer under the Measures may provide a valuable reference.

ii. Special guidelines for pricing in acquisition of SOEs

Taking into account the large-scale loss of state-owned assets that occurred frequently in previous restructurings of SOEs, especially in management buy-outs of SOEs, for pricing in acquisition of SOEs, guidelines governing restructuring of SOEs reads that managers buying the state-owned assets of their own companies are banned form participating in key decision, such as determination of price and self-interested purchases are strictly prohibited and the departments in charge of the SOE must determine the price of the state-owned assets. The appraisal price is an essential reference, but the price might also be affected by elements such as market supply and demand for the assets, the price of other comparable assets on the market, the terms of the employees' settlement plan and the introduction of advanced technologies. For listed companies, the price of state-owned shares should be set according to the company's performance and profits, and above the net asset value of each share.[451]

iii. Important role of independent financial advisers and developing the professional institutions

It is noted that the recently promulgated legislation has recognized that the target company's independent directors and financial advisers have a key role to play when an offer for the company is made by a management team. For acquisition of a listed company by its management by agreement, the Measures make it incumbent on the independent directors to

[451] The Proposal by SASAC for Guidelines Governing Restructuring of State-owed Enterprises, Article 1(6),(7).

express opinions on the impact such acquisition may produce on the company and require the company to retain a professional institution such as an independent financial advisor to provide an advisory opinion, which shall be publicly announced together with the opinions of the independent directors.[452] Also in an acquisition by public offer[453], if management or staff and employees undertake the acquisition of a listed company, the independent directors of the company to be acquired shall engage a professional institution such as an independent financial advisor to analyze the financial condition of the company to be acquired and issue a professional opinion on matters such as whether the terms of the acquisition public offer are fair and reasonable and the possible effects of the acquisition on the company and make a public announcement of the same.[454]

In both situations, the financial advisers must assess all available information, take into account the possible change of management style should a buy-out proceed and recommend in clear terms to the target's shareholders whether or not the pricing is reasonable. They may also consult with the target's auditor, industry experts and economic and marketing consultants.

Therefore, expertise on appraisal of the target issued by professional institutions can provide a

[452] The Measures for Administration of Acquisition of Listed Companies, Article 15.

[453] The Measures for Administration of Acquisition of Listed Companies, Article 23. "When a purchaser holds or controls at least 30% of the already issued shares of a listed company, and it continues to increase its shareholding of such company or increase its control of such company, it shall by means of a public offer make an acquisition offer to all shareholders of the company to buy all of the shares they hold."
The Measures for Administration of Acquisition of Listed Companies, Article 62 (a). "The term "acquisition by public offer" means a purchaser's openly-issued expression of an intention to shareholders of a company to be acquired to the effect that such purchaser wishes to buy the shares in the company to be acquired held by such shareholder pursuant to the terms of the public offer."

[454] The Measures for Administration of Acquisition of Listed Companies, Article 31.

fair and reasonable groundwork for pricing in the management buy-outs. It is crucial to develop and manage the professional institutions in China including accounting firms, law firms and asset appraisal organizations to provide professionally devoted, precise, efficient, practical and innovative financial and accounting evaluation businesses.

iv. Introduce competing bids

Finally, non-marketable shares are held by government departments or their authorized corporations. On the purchaser side, other than internal management members, external purchasers are excluded from the negotiation with the shareholders or offering a bid to the shareholders. So the pricing in the acquisition of the non-marketable shares of the target company is usually agreed between the shareholders and management and a lower price based on undervalued assets of the target is easily accessed by the management. To stress the urgency of increasing transparency in price negotiation of management buy-out transactions, it is necessary to invite competing bidding whereby the owners of a business invite bids from trade buyers alongside management's bid.

Practically, the Proposals require that the management buy-outs involving state-owned assets shall be conducted by way of competitive bidding in the open market for ownership transfer in the case of non-listed companies. Also, the Measures consider that the shareholders of a listed company can transfer the shares of the listed company they hold through public solicitation upon approval by the CSRC and the stock exchange.[455] In the future, express and definite rules in this respect should be provided by the Chinese government.

[455] The Measures for Administration of Acquisition of Listed Companies, Article 21.

5. Duty of information disclosure under Chinese Law

Both the common law and statute law in UK contain rules requiring directors to disclose the existence and nature of any personal interest which they have in a contract to which their company is a party.

However, as I have mentioned before, in most Chinese management buy-outs, where information on the purchaser, pricing, financing resource are not open to the public, a risk of violation of relevant Chinese law may occur. Usually, management have easy access to the inside information of the target under their control; in order to avoid self-interested transactions and protect the rights and interests of the target's shareholders, creditors and state-owned assets, the duty of information disclosure should be imposed.

Formerly, only the Securities Law provides general rules on information disclosure, for instance, a stockholder shall notify the company within three days when the stocks in his possession have reached 5% of the stocks issued by a joint-stock limited company. The company shall report it to the securities regulatory body under the State Council within three days of receipt of the report. Where the company is listed, it shall also report it to the securities exchanges.[456]

Later, in accordance with the Securities Law and the Company Law of the PRC, the Administrative Rules of Information Disclosure on Change of Shareholding in Listed

[456] The Securities Law of PRC, Article 41.

Companies which took effect in December 2002 requires the person who bears the obligation to disclose change of shareholding as to the shareholders of listed companies to strictly carry out their information disclosure obligations, and the information disclosed by them shall be authentic, accurate, complete, and without false records, misleading statements or major omissions. The rules also set out the obligations of the shareholders, controlling persons and persons acting in concert, together with the disclosure procedures.

In addition, the concept of persons acting in concert in UK has been first imported in China and the information disclosure obligation is expanded to persons acting in concert.[457] In the City Code of the U.K., persons acting in concert comprise persons who, pursuant to an agreement or understanding (whether formal or informal), actively co-operate, through the acquisition by any of them of shares in a company, to obtain or consolidate control of that company.[458] Similarly, in China persons acting in concert refer to two or more natural persons, legal persons or other organizations that make the same declaration of will when exercising their voting power of the listed company to increase their holding of shares in the listed target company or to consolidate their control of the listed company by legal means such as agreement, cooperation, association relationship, etc.[459] In the result, where there is a management buy-out through a vehicle company formed for the purpose of making an offer, the Newco, management of the target and institutional investors in a consortium will normally be treated as acting in concert with the offeror, and the onus of information disclosure lies

[457] The Administrative Rules of Information Disclosure on Change of Shareholding in Listed Companies, Article 6.
[458] The City Code of UK, Definition.
[459] The Administrative Rules of Information Disclosure on Change of Shareholding in Listed Companies, Article 9.

with them.

Recently, particular rules on duty of information disclosure are progressing. For instance, four guidelines for contents and formats for information disclosures by companies that offer securities to the public, No. 15 Guidelines for change of shareholdings in listed companies report, No.16 Guidelines for listed company takeover report, No.17 Guidelines for takeover by offer report and No.18 Guidelines for report of target company's board of directors, were promulgated by CSRC.

In accordance with the No. 15 Guidelines, management is required to prepare a report and disclose a change of shareholdings in the listed company.[460] The report shall disclose the details of the information including disclosure obligors, change of their shareholdings in the relevant listed company, trading of the listed shares in the listed company. The directors or principal responsible persons of the information disclosure obligor shall be jointly and severally liable for the truthfulness, accuracy and completeness of the contents of the report[461]

Management is also required to prepare a Listed Company Takeover Report in accordance with the No. 16 Guidelines and a Takeover by Offer Report pursuant to the No. 17 Guidelines to disclose the details of the purchasers, their shareholdings in the target company, trading of the shares in the target company during the last six months, major transactions between the

[460] China Securities Regulatory Commission, Contents and Formats for Information Disclosures by Companies that Offer Securities to the Public Guidelines (No. 15): Change of Shareholdings in Listed Companies Report, Article 2.
[461] China Securities Regulatory Commission, Contents and Formats for Information Disclosures by Companies that Offer Securities to the Public Guidelines (No. 15): Change of Shareholdings in Listed Companies Report, Article 11.

purchasers and the target company, source of funds for the takeover, any action to be taken in relation to the target company following the takeover, impact of the takeover on the target company and financial information of the purchaser.[462]

Significantly, both the No. 15 and the No.16 Guidelines provide specific rules for information disclosure obligations of management in management buy-outs. It is required that particular information shall be disclosed in management buy-outs, including the shareholdings of the management in the target or the Newco, basis of pricing, payment, funding source and repayment plan. Directors shall testify their duty has been performed and there is no violation of the rights and interests of the target and other shareholders.[463]

The No. 18 Guidelines prescribe that the board of directors of the target company in a takeover transaction shall prepare a board of directors' report.[464] In the report, apart from the basic information of the target company, any conflict of interests management have in the takeover transaction shall be disclosed.[465] For example, any connection between the management and the Newco shall be disclosed including the shareholdings of the management in the Newco or any relationship between the management of the target and the

[462] China Securities Regulatory Commission, Contents and Formats for Information Disclosures by Companies that Offer Securities to the Public Guidelines (No. 16): Listed Company Takeover Report, Article 2. China Securities Regulatory Commission, Contents and Formats for Information Disclosures by Companies that Offer Securities to the Public Guidelines (No. 17): Takeover by Offer Report, Article 2, 13. 14.

[463] China Securities Regulatory Commission, Contents and Formats for Information Disclosures by Companies that Offer Securities to the Public Guidelines (No. 15): Change of Shareholdings in Listed Companies Report, Article 32. China Securities Regulatory Commission, Contents and Formats for Information Disclosures by Companies that Offer Securities to the Public Guidelines (No. 16): Listed Company Takeover Report, Article 31.

[464] China Securities Regulatory Commission, Contents and Formats for Information Disclosures by Companies that Offer Securities to the Public Guidelines (No. 18): Board of Directors' Report, Article 2.

[465] China Securities Regulatory Commission, Contents and Formats for Information Disclosures by Companies that Offer Securities to the Public Guidelines (No. 18): Board of Directors' Report, Article 18, 19, 23.

management of the Newco.[466] Like the City Code of the U.K.[467], where a director has a conflict of interest, he should not normally be associated with the remainder of the board in the expression of its views on the acquisition and the nature of the conflict should be clearly explained to shareholders.[468] Additionally, in the case of an acquisition of the target by the management, the recommendation or statement from the board of directors shall consist of the opinions provided by the independent directors on the funding resources of the acquisition, any unfairness and reasonableness of the acquisition condition, any activity violating the rights and interests of the target and other shareholders and any contingent effect of the acquisition on the target.[469] Furthermore, in the event that a management buy-out occurs, the opinions of an independent financial advisor shall be provided on whether the independent financial advisor is related to the acquisition and whether the valuation and the price of the target is fair.[470]

The purpose of the existing rules and guidelines relating to obligation of information disclosure is to ensure fair, equal and transparent treatment of all shareholders in relation to management buy-outs and apply responsibilities to those who are actively engaged in the transactions including directors, vehicle companies and professional advisors. In practice, however, the information disclosure mechanism is still deficient. The reasons are three fold. First, the above rules are issued by the CSRC which is an enterprise unit directly under the

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[466] China Securities Regulatory Commission, Contents and Formats for Information Disclosures by Companies that Offer Securities to the Public Guidelines (No. 18): Board of Directors' Report, Article 21, 22, 26.
[467] The City Code of UK, Rule 25.1, Note3, 4.
[468] China Securities Regulatory Commission, Contents and Formats for Information Disclosures by Companies that Offer Securities to the Public Guidelines (No. 18): Board of Directors' Report, Article15.
[469] China Securities Regulatory Commission, Contents and Formats for Information Disclosures by Companies that Offer Securities to the Public Guidelines (No. 18): Board of Directors' Report, Article 29.
[470] China Securities Regulatory Commission, Contents and Formats for Information Disclosures by Companies that Offer Securities to the Public Guidelines (No. 18): Board of Directors' Report, Article 30.

State Council.[471] In accordance with the structure of the lawmaking powers in China, regulations and rules issued by ministries and commissions under the State Council are, in general, at a lower lever and more limited in nature. Their application is generally not stable within the sphere of the function of the ministry in question.[472] Second, the information disclosure regulations do not specify what consequences would follow from contravening the duties of information disclosure. For instance, the directors or principal information disclosure obligor shall be jointly and severally liable for the truthfulness, accuracy and completeness of the contents of the report,[473] but where there is an issuance of a false, misleading or otherwise dishonest opinion by them, the question of the extent of the civil liability of the management for breach the rule in not answered.[474] Finally, when management buy-outs of unlisted companies exist, there is no specific rule for duty of information disclosure in the acquisition of unlisted companies to apply.

6. Duties of management

A. Director's duties under Chinese Law

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[471] In 1998, the State Council approved the Provisions regarding CSRC's Functions, Internal Structure and Personnel, confirming CSRC to be one of the enterprise units directly under the State Council and the authorised department governing the securities and futures markets of China.

[472] *Supra* note 316 for detailed explanation.

[473] China Securities Regulatory Commission, Contents and Formats for Information Disclosures by Companies that Offer Securities to the Public Guidelines (No. 15): Change of Shareholdings in Listed Companies Report, Article 11.

[474] The Administrative Rules of Information Disclosure on Change of Shareholding in Listed Companies, Article 34 "If a disclosure obligor fails to perform the relevant obligations pursuant to the present Measures, it shall make voluntary corrections; for its failure to correct, the stock exchange shall deal with it pursuant to its professional rules, and the securities registration and settlement institution shall suspend processing the formalities for transfer of share ownership for it pursuant to its professional rules; if the obligor refuses to correct, CSRC shall order it to correct. In case of any violation of the securities laws and regulations, the legal liabilities shall be investigated pursuant to the law." Article 35 "If the information disclosed by the disclosure obligor contains false records, misleading statements or major omissions, it shall make voluntary corrections; for its failure to correct, the stock exchange shall deal with it pursuant to its professional rules, and the securities registration and settlement institution shall suspend processing the formalities for transfer of share ownership for it pursuant to its professional rules; if the obligor refuses to correct, CSRC shall order it to correct. In case of any violation of the securities laws and regulations, the legal liabilities shall be investigated pursuant to the law."

As was discussed in chapter 4 above, duties of the directors are emphasized in UK. The framework of fiduciary duties under common law is that directors are required to act bona fide to the benefit of the company, to exercise their power for the proper purpose, and not to allow for any conflict between their duties as directors and their personal interests. In addition, directors' obligations are imposed by employment agreement and their statutory duties. Also the City Code of the U.K. also imposes relevant duties on directors in a management buy-out.[475]

A number of similar obligations or duties are imposed on company officers including directors, managers and supervisors(discussed below) of Chinese companies under the Company Law of the PRC. These duties are codified both in respect of limited liability companies and joint stock companies. Directors, supervisors and the manager shall be liable for compensation, if they breach the duties stipulated by the Company law, administrative rules and regulations or the articles of association and thus cause damage to the company.[476]

Although, the concept of fiduciary duties at common law can not be found in Chinese company law system, there are a number of similarities between the Chinese and the common law system.

i. Abide by the Articles

In the first instance, the Chinese Company Law requires directors, managers and supervisors to act in accordance with the company's articles of associations and perform their duties

475 See Chapter 4, III MBOs concerning public companies, above.
476 The Company Law of the PRC., Article 63.

faithfully in the interests of the company.[477]

In addition to the general obligations, they are not permitted to take advantage of their positions, functions and powers in the company to seek or obtain personal gains. Despite the obvious differences between the two forms of jurisprudence, such a requirement can be read in the light of similar requirements under the common law to reflect the fact that the directors must put the company's interest first and certainly before their own.

ii. Abuse of power

Directors, supervisors and managers are prohibited from using their powers of office to accept unlawful incomes, nor may they misappropriate the property of the company.[478] Also, directors and managers are prohibited from embezzling funds or lending company funds to others.[479] This protection is extended to financial assistance, so that directors and managers are also prohibited from using company assets to provide a guarantee for personal debts payable by the company's shareholders or other persons.[480] Like the discussion above on financial assistance, it is also arguable that such a prohibition is most relevant to the financing problems in management buy-outs.

iii. Conflict of interests

The Company Law seeks to prevent directors or managers from engage in any activities that may cause damage to the interests of the company of which they are directors or managers,

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477 The Company Law of the PRC., Article 59, 123.
478 The Company Law of the PRC., Article 59,123.
479 The Company Law of the PRC., Article 60.
480 The Company Law of the PRC., Article 60..

otherwise, any profit obtained through those actions must be repaid to the company.[481] The prohibition on competition is also extended to a director have a position of conflict of interests with the company.

This is particular identical to the provisions under the common law and statutory law in UK which stipulated that unless provided for in the company's articles of association or approved by the board of directors, a director or manager is not permitted to conclude contracts or to conduct business with his own company.

iv. Confidentiality

To complete the protection provided to the company and its assets, the Company Law of the PRC has adopted the common law formulation regarding maintaining a company's confidential information unless required by law or approved by the board of directors.[482]

v. New legislation introducing the concept of "fiduciary duty"

A newly-described duty of care, "*chengxin yiwu*"[483] which is synonymous with "fiduciary duty" is introduced in the Measures for Administration of Acquisition of Listed Companies. In the case of acquisitions in listed companies, directors, supervisors and senior officers of a listed company shall have a fiduciary duty to the listed company they hold positions in and such company's shareholders. While it seems certain that this is not meant to import wholesale "fiduciary duty" and standards of care developed under better elaborated jurisprudence in United Kingdom, this does represent the first time such a duty has been

[481] The Company Law of the PRC., Article 61.
[482] The Company Law of the PRC., Article 62.
[483] The Measures for Administration of Acquisition of Listed Companies, Article 9.

explicitly identified in a Chinese statute, with a description as to whom precisely the duty is owed – the company and the other shareholders.[484]

Notwithstanding the import of new duties, there is no explicit right granted to individual shareholders to bring a cause of action against breaching purchasers, officers, directors, etc. This is consistent with the Securities Law, notwithstanding the immense pressure in China from private shareholders to bring private actions against illegal behavior. By the same token, the Measures do not forbid private suits, and we may thus expect pleadings by aggrieved minority shareholders and other actors in the near future.

B. Approaches for minimizing the conflict of interest.

i. Revision of Company Law

How to properly provide for the rights, duties and responsibilities of directors and limit the activities of directors and other senior officers is thus one of the key tasks of company law in China. Since the existing company law only has some general provisions on the passive office qualification, duty of loyalty and legal liabilities of directors and managers, in the revision of the Company Law of the PRC., the active office qualifications of directors should be added, the status of directors should be clarified, the obligations of directors should be added, and the civil liabilities as a result of a breach of such obligations shall be provided in detail.

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[484] The only previous attempt to import fiduciary duty into PRC law on corporations was in the letter from the now-defunct Commission on Restructuring of the Economic System ("CRES") to the Hong Kong Stock Exchange of June 1993 in connection with proposed Hong Kong or "H" share listings of PRC companies. In that letter, CRES assured Hong Kong regulators that a form of words in Article 62 of the now superseded "Opinion on Standards on Companies Limited by Shares" (subsequently absent in the PRC Company Law, but reinstituted for overseas issuers in the CSRC's "Overseas Listing Rules") had "… the same meaning as 'chengxin zeren [fiduciary duty]' of Hong Kong law."

ii. Introduce independent directors to the board of directors

Moreover, due to the independence of the independent directors from other directors involved in the management buy-outs, the employment of independent directors in supervising such transactions is paramount to protect the target's assets and the shareholders' benefits, particular the minorities' interests.

It is the Guidelines for Introducing Independent Directors to the Board of Directors in Listed Companies issued by CSRC that first introduce the concept of the independent director. To further improve the governance structure of listed companies and standardize their operation, CSRC issued the Code of Corporate Governance for Listed Companies in China. Thus introducing independent directors to listed companies' board become compulsory. Independent directors introduced to the board of directors in a listed company shall not hold any other position in the listed company and shall be independent from the listed company, the company's major shareholders, directors, managers and other interested parties. At least one of the independent directors should be an accounting professional and one third of board shall be independent directors. They owe the duties to the listed company and all the shareholders to act in good faith and due diligence in accordance with laws, regulations and the company's articles of association. And they shall perform their duties faithfully to protect the overall interests of the company and shall particularly protect the interests of minority shareholders from being infringed.[485]

[485] The Code of Corporate Governance for Listed Companies in China, Article 49, 50. The Guidelines for Introducing Independent Directors to the Board of Directors of Listed Companies, Article 1.

In the context of management buy-outs, to protect the listed company's assets and shareholders, the Measures impose duties on independent directors not only to independently express their opinions on the impact such acquisition may produce on the company but also engage a professional institution such as an independent financial advisor to provide an advisory opinion.[486] However, in an ordinary acquisition, independent directors own no duty to require the target company to engage an independent advisor. Hence, the necessary role of independent directors who maintain no relations with the listed company and its major shareholders that might prevent them from making objective judgment independently is consolidated.

However, legislation in respect to the newly imported role of independent directors needs to be improved. First, the independent director's role shall be imported in a statute at a high level such as the Company Law of PRC, and specific rules on their powers, duties need to be respectively provided. Especially in management buy-outs, duties shall be fully imposed on the independent directors to engage professional institutions including lawyers and financial advisors for obtaining objective and independent opinions as to whether such transactions are viable and whether the purchase price is fair and reasonable. Also, their liabilities as a consequence of a breach of their duties shall be clarified. Second, the independence requirements shall be emphasized in legislation. According to the existing legislation, independent directors' independence is questionable because the election of independent directors is only based on the nomination by the board of directors and shareholders,[487] and

[486] The Measures for Administration of Acquisition of Listed Companies, Article 15, 31.
[487] The Guidelines for Introducing Independent Directors to the Board of Directors of Listed Companies, Article

independent directors' remuneration is decided by the boards and paid by the employee company. Thus, to make them adequately independent from shareholders and other directors, it is advisable that a national institution composed of independent directors can be incorporated to provide professional and qualified members to the board of directors of a company and independent directors' remuneration shall be paid by such an institution.[488] Third, the proportions of independents directors in the company's board and specialized committees shall be increased.[489]

iii. Supervisory board

Another variation on the common law is the supervisory board of a company. Although the employment of independent directors has been a practice in China for the enhancement of corporate governance, the independent director system cannot completely replace the supervisory board system. It may be realistic choice in China to further enhance the supervisory broad system and strengthen the rights and duties of supervisory boards.

The supervisory board composed of representatives of the shareholders and an appropriate proportion of the employees of the company, is constructed only in respect of a large limited liability company.[490] And the exact proportion is stipulated in the articles of association. To reinforce the independence of the supervisory committee from the company's executives, none of the directors, managers or senior financial personnel are permitted to act as

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[488] Xie Nana, *Research on MBOs in China and Relevant Legal Issues* (LLM. Thesis, Shanghai Institute of Foreign Trade, Nov 2003) [unpublished].

[489] Zhang Xianzhong, "Research on Legal Problems arising form Management Buy-outs of Listed Company", Shanghai Stock Exchange, online: < http://www.sse.com.cn/ps/zhs/sjs/xw/ssenews20030606.html>.

[490] The Company Law of the PRC., Article 52.

supervisors. The powers of this independent body are extensive with the supervisors effectively constituting the watchdog of the company's assets and activities.[491] In the same way, duties of the directors and managers under Chinese company law are imposed on the supervisors. When a management buy-out takes place, the supervisors of the target company can exercise their powers to investigate the target's financial affairs, supervise acts undertaken by directors and managers during the performance of their duties and request directors and managers to rectify their conduct where such conduct may be detrimental to the interests of the company.[492]

It shall be noted that duties imposed by current Chinese Law on the independent directors and supervisors in a company may overlap. Hence, it is recommended to clarify the division into their powers so as to completely protect the shareholders and the company.[493] For example, for the independent directors, duties may mainly be imposed on them to monitor whether the transactions including management buy-outs are beneficial to the target company, whether the proposed structure of such transactions is fair and reasonable, and whether there is any possibility of violating the rights and interests of the minority shareholders and any probable risk arising from such transactions. For the supervisors, duties may be imposed to supervise whether such transactions contravene relevant legislation.

491 *Ibid.*
492 The Company Law of the PRC., Article 54.
493 Meng Gang, *Legal Issues in MBOs in Listed Companies* (LLM. Thesis, Peking University, 2003) [unpublished].

Chapter 6: Prospect of future development of China's law regarding MBOs

It is the same situation as that in UK that the general regulation of MBOs in China is separated in many different areas such as the Company Law, the Securities Law, and other laws. However, in spite of the practice, the legal environment is still unprepared for full-fledged MBOs. Neither regulations nor judicial precedents are adequate in elaborating on the exact nature of MBOs, the corporate manager's duties to their companies and minimize conflict of interests in MBOs scenarios. Therefore, it is necessary to propose cautious amendments to relevant laws governing management buy-out transactions.

I. Revision of certain regulations and import of new regulations

It is for the reason that the Company Law and Securities Law were passed many years ago, the stipulations in them may be unreasonable and inconsistent with present practices and needs. For example, a statutory obligation imposed by the Company Law on the Newco, a shell vehicle when it invests in the target, that the amount of such investment shall not exceed fifty percent of its net assets seems to be too stiff and makes a negative impact on some innocent transactions including management buy-outs.[494] Another example is that the incorporation of Newco is restricted that it shall be jointly invested in and incorporated by not less than two and not more than fifty shareholders.[495] In order to pave the way for innocent management buy-outs, a shell company such as Newco shall be allowed by the Company Law to be incorporated for the mere purpose of investment and holding equity in other companies and the threshold for its investment in other companies shall be removed.

[494] The Company Law of the PRC, Article 12.
[495] The Company Law of the PRC, Article 20.

Also, it is most likely that directors, managers and senior administrators of a target company in management buy-outs are personnel with inside information as they can have access to relevant information because of their offices in the company they serve.[496] But according to the Securities Law of the PRC, insiders of securities trading with inside information shall be completely prohibited from carrying out securities trading operations by taking advantage of the inside information.[497] The said rules prohibiting management team being involved in the management buy-out transactions are repugnant with the Measures which admits the legality of the management buy-outs in the listed company for the first time in Chinese Law. Amendments to current inconsistent rules may avoid uncertainty and confusion.

Moreover, other relevant laws adopted before the explosion of the management buy-outs which may include unreasonable obstacles to the practical conduct of management buy-outs or may be in the lack of coordination in themselves shall be revised or eliminated. One example of the unreasonable obstacles largely limiting the conduct of China's MBOs is the prohibition on debt finance provided by banks in a management buy-out prescribed both by the General Rule of Loan[498] and by the Commercial Banks Law of the PRC.[499] Another example of discrepancy is the disclosure obligation imposed on an investor who starts to hold or control more than 5% of the shares issued by a listed company by the Administrative Rules of Information Disclosure on Change of Shareholding in Listed Companies[500] which

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[496] The Securities Law of PRC, Article 68.
[497] The Securities Law of PRC, Article 67.
[498] The General Rule of Loan, Article 71.
[499] The Commercial Banks Law of the PRC., Article 43.
[500] The Administrative Rules of Information Disclosure on Change of Shareholding in Listed Companies, Article 7,

contradicts the prohibition that an individual is not allowed to hold more than 0.5% ordinary shares issued by a listed company.[501]

In proposed revisions, there shall be some relaxation to the debt finance that commercial banks shall be permit to provide debt finance for equity investment and some legislation should be provided to facilitate the finance provided by investment funds, pension funds, insurance companies and other institutional investors in management buy-outs.

It should be also noted that in the absence of regulations elaborating on director's duties to the target company and its shareholders and lack of explicit prohibitions on financial assistance with certain relaxations, conducting a management buy-out where management have their own interests may run a risk of violating the assets of the target company and interests of the shareholders.[502] Statutory provisions and common law practice in this respect under UK law could be respectively imported into the Chinese legislation according to the practice in China.

Thus, merely applying the current laws to management buy-outs is not enough, revising them to better serve the purpose of governing existing and imminent activities is necessary. It is hoped that the new Company Law could combine the merits of the current Chinese Company Law, relevant supplemental regulations and sophisticated modern English law, while eliminating the defects and unreasonable prohibitions from the current Company Law.[503] Such

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501 The Interim Measures for Administration of Share Issuing and Dealing, Article 46.

502 See Chapter 6, above, for separate discussion.

503 Yang Hongsheng, *Proposal of Legal Framework for MBOs* (LLM. Thesis, China University of Politics & Law, May 2003) [unpublished].

improvements are also respected for other relevant laws.

II. A unified code-Management buy-outs Code(“the Code”)

A unified code could also avoid legal loopholes and discrepancies existing in the present laws. Some important issues were not addressed in the current laws, for example, for the first time in Chinese legislation, the Measures impose a duty on independent directors to express their views where there is a management buy-out of listed companies, but regrettably, the law is silent on such a crucial problem of conflict of interests arising in management buy-outs of un-listed companies. Moreover, while some regulations including the Measures incorporate rules guiding such an activity as management buy-outs, the other regulations previously adopted including the Company Law and the Securities Law place a barrier to the exercise of management buy-outs in practice. It reflects the lack of coordination in the recent laws themselves. Therefore, it is expected that in a unified code these legal loopholes and discrepancies could be fixed.

Optimistically, early in April 2003, Mr. Jia Chan, head of the Enterprise Section of Ministry of Finance(“MOF”) said that the MOF would concentrate on the promulgation of management rules for management’s acquisition of Listed Companies.[504] It was also noticed that the SASAC is studying laws and regulations pertaining to management buy-outs.[505] Thirteen subjects, including issues concerning the authorized operation of state-owned assets,

[504] O’Melveny & Myers LLP, China Law & Policy Digest(30 April 2003), (China Securities Journal), April 22, 2003), “Ministry of Finance (MOF) to Perfect Financial Systems through Promulgation of MBO Management Rules for Listed Companies.” online: <http://www.omm.com/webdata/content/publications/clp030430.pdf>.

[505] O’Melveny & Myers LLP, China Law & Policy Digest (21 November 2003) “SACSAC is studying Laws and regulations regarding MBO methods” online: <http://www.omm.com/webdata/content/publications/clp031121.pdf>.

administrative measures for the resolution disputes over the ownership of state-owned assets, utilization of corporate counsel and assessment measures for operational performance of state-owned assets, are on the schedule recently. It was also emphasized that all MBOs in China will be overseen by the SASAC to prevent the loss of state-owned assets and to create equal opportunities for all investors.

1. General Principles

Management buy-outs in China are complex activities, which not only concern the interests of the target, shareholders and management, but also impact on the benefits of the state and public society when state-owned assets are involved. Therefore, the Code should be based upon a number of General Principles, which are essential statements of standards of commercial behaviour in management buy-outs. These General Principles apply to all management buy-outs transactions.

Firstly, the Code's principle is to devise rules to ensure fair and equal treatment of all shareholders in relation to management buy-outs and provide an orderly framework within which management buy-outs are transparently conducted.[506] Secondly, persons who are actively engaged in such transactions should be aware of the spirit of the Code and have a responsibility to ensure the Code is complied with in the conduct of management buy-outs. The boards of the target company, engaged management and their respective advisors have a

[506] Peng Zhenming & Chang Jian, "Improve the Legislation Concerning Management Buy-out: Protect the State-owned Assets"(Feburary 19 2004), , online: China Civil Law <http://www.civillaw.com.cn/weizhang/default.asp?id=13248>.

duty to act in the best interests of the target and shareholders, particularly in the context of the pricing in a management buy-out. Also, rights must be exercised in good faith and the oppression of a minority is wholly unacceptable. Thirdly, all parties in the management buy-outs must use every endeavour to prevent the loss of state-owned assets.

2. Contents of the proposed Management Buy-out Code

The following contents can be incorporated into the Code:

A. Target company

Considering the level of economic development in china, in the "junior period of socialist market economy" as defined by the Chinese government, China still needs to protect certain state-owned industries indispensable to the whole country including energy sources, infrastructure and finance and keep a certain degree of control over such industries. Thus, the state shall still hold equity concerning lifelines of the national economy and national security and in such enterprises engaged in the fields of important infrastructure and natural resources on behalf the State. So, not all management buy-outs are desirable as some industries may be reserved for national investment. Taking this reality into account, the target companies which could be acquired by their management shall exclude those companies engaged in the industries exclusively controlled by the state investment.[507]

In terms of the target companies which management are allowed to acquire, the Code may contain contents of three aspects. The first aspect is ownership guide. Provisions either

[507] *Ibid.*

reserve certain economic sectors for the state or define certain sectors in which a certain proportion of private capital is permitted to participate could be a guide for determining in what economic sectors management buy-outs are forbidden. The second is government supervision. The government should screen the proposed management buy-outs and decide whether to approve it or not according to the guide. The third may be commercial criteria for characteristics of a target in management buy-outs. In practice, some scholars found a target with consistent track record of turnover and profit growth or demonstrable scope for improvement, in a strong competitive position within a growing, stable industry, has a spread of products and services, not unduly dependent on any particular customer or supplier, and with strong asset backing or demonstrable cash generation may be predicated to help a buy-out in China[508]

B. Define the management, co-operative institutional investor, nature and structure of management buy-outs.

Qualified management engaged in management buy-outs according to the Code shall be restricted to directors and senior managers of the target, who can run the target independently with great competence and experience, provide sufficient financing resources by legal means, have contributed much for the prosperous operation of the company, and always act faithfully in the best interests of the company. In order to avoid a conflict of interest, independent directors and supervisors shall be prohibited to be engaged in management buy-outs and be prevented from having any associations with the interested management. A group of

[508] Peng Zhenming & Zhou Zifan, "Legal Analysis of MBOs", 2003(3), Law Science (Transactions of Northwest University of Political Science & Law), 112.

management should be restricted from participating in the management buy-outs, including government functionaries, management without capacity or with restricted capacity for civil activities, management who undertook criminal liabilities for the crime of misappropriation of the company's property or for undermining the socio-economic order, management who were personally responsible for the bankruptcy liquidation of the company due to mismanagement and management with relatively large amounts of personal debts that have fallen due but haven't been settled.[509]

Besides, following the revision to the Company Law and relaxation to the finance limitation, in the conduct of management buy-outs, a shell company, Newco is allowed to be incorporated to acquire the shares or business of the target and management and the institutional investor could subscribe for shares in Newco. Also debt and equity finance models should be illustrated in detail in the Code. Finally a well-found pricing mechanism should be devised for all management buy-outs including acquisition of unmarketable state-owned shares and corporate shares in listed companies, marketable shares in listed company, unlisted state-owed enterprises, unlisted collectively-owned or private enterprises.

C. Impose obligations of information disclosure and the consequences following the breach of the obligation.

In order to avoid self-interested transactions and protect the rights and interests of the target's shareholders, creditors and state-owned assets, the duty of information disclosure should be

[509] The Company Law of the PRC., Article 57, 58.

imposed in the Code.[510] First, obligations of information shall be applied not only to management buy-outs of listed companies, but also to the management buy-outs of unlisted companies. Second, information disclosure obligations shall be extended to the Newco, management of the target and institutional investors in a consortium. Third it is required that particular information shall be disclosed in management buy-outs, including the shareholdings of the management the Newco, basis of pricing, payment, funding sources and repayment plan. Finally, the Code shall specify the liabilities which directors or principal information disclosure obligor shall be subject to, as a consequence of breach of duty of information disclosure.

D. Director and supervisor's duties

Despite the general duties imposed on directors by the Company Law of PRC., the Code shall impose more onerous duties on directors in the case of management buy-outs. And supervisors in the target company shall not participate in the management buy-outs and shall keep a close eye on the conduct of such transactions. Where a management buy-out takes place, the supervisors of the target company can exercise their powers to investigate the target's financial affairs, supervise acts undertaken by directors and managers during the performance of their duties and request directors and managers to rectify their conduct where such conduct may be detrimental to the interests of the company.

Over all, a unified MBO code can be justifiable, since it will avoid discrepancies and legal

[510] Li Yangming, *Research on Legal Issues of MBOs* (LLM. Thesis, China University of Politics & Law, May 2003) [unpublished].

loopholes and simplify the legal framework to make it more accessible for management and investors.

III. Supervision and Government administration

To stress the independence of independent directors to supervise the transactions where management have their interests, it is advisable that a national institution composed of independent directors can be incorporated and to provide professional and qualified members to the board of directors of a company and independent directors' remuneration shall be paid by such an institution. Rules guiding and governing such an institution should be devised accordingly.[511]

In management buy-outs, it is necessary for the financial advisers to assess all available information, take into account the possible change of management style should a buy-out proceed and recommend in clear terms to the target's shareholders whether or not the transaction is fair and reasonable. They may also consult with the target's auditor, industry experts and economic and marketing consultants. It is crucial to develop and manage the professional institutions in China including accounting firms, law firms and assets appraisal organizations to provide professionally devoted, precise, efficient, practical and innovative financial and accounting evaluation business.[512]

To prevent loss of state-owed assets, and protect the shareholders of the target company,

[511] Peng Zhenming & Zhou Zifan, *supra* note 508.
[512] *Ibid*.

management buy-outs concerning transfer of shares and assets in a company with a large scale of state-owned assets should be subject to government examination and approval. The procedure of examination and approval and the responsibilities should be respectively established for Regulatory authorities including CSRC, SASAC and MOF.[513]

IV. State-owned Property Law governing MBOs of state-owned company

A unified state-owned property law is necessary to specify the ownership of state-owned assets, classification of state-owned assets, valuation of classified state-owned assets, pricing of state-owned shares, procedure of state-owned shares and assets transfer, and approval and examination procedure. As current management buy-outs frequently occur where the management intends to purchase the illiquid state-owned shares by agreement, confusion of the vendor whom the management shall negotiate with, and uncertainty of the basis of pricing the state-owned shares may be avoided, if the State-owned Property Law is applicable. Finally, the supervisory responsibility of relevant authorities in compliance with the approval and examination procedure is most likely to prevent the loss of the state-owned assets.

Chapter 7: Conclusion

Management buy-outs are now a world-wide phenomenon, however, their nature and extent varies considerably from country to country, depending upon the particular characteristics of individual business, industrial base, financial and entrepreneurial backgrounds. In addition, the present state of MBOs in any country depends upon the stage reached in the life-circle of

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[513] Li Yangming, *Research on Legal Issues of MBOs, supra* note 510.

this form of ownership change.

MBOs originated in UK in the late1970s and spread rapidly in the early 1980s. The backgrounds to improvements arising from MBOs can be seen in consideration of both agency cost theory and entrepreneurship theory.[514] The majority of the sources of MBOs in UK are divestments of non-core business by UK listed companies.[515] The development of the MBOs business in UK has been accompanied by an increase in the number and size of financing institutions and in the scope of the service they offer.

In China, the management buy-out is a new development. The deals were frequently motivated by China's market-orientated economic reform. State-owned asset needs to be reallocated, which must bring the transfer of ownership of a large number of stated-owned assets to individuals. In such an economic situation, the MBO is employed by many enterprises and is supposed to be essentially a device to clarify property rights and excite management. Also, some legislation has also facilitated the growth of MBOs.

Management buy-outs are an important innovation in China's economic reform. However, in spite of the issuance of several supportive rules and regulations pertaining to MBOs over the past years, there remain quite a lot of obstacles and risks when conducting the deals under the Chinese legal regime. Moreover, China has an undeveloped capital market, the industrial banks have had problems with both debt finance and equity investments, and the venture

[514] Mike Wright & John Coyne, *supra* note 6 at 41-53.
[515] Janette Rutterford & David Carter, eds., *Handbook of UK Corporate Financ*e, (London: Butterworths, 1988) at 60.

capital market in China, unlike UK is at an early stage of development. Therefore, relative laws and regulations should be improved or established as soon as possible in order to take advantages of MBOs during the special period of state-owned enterprises' reform.

One can gain a wider perspective of the importance of MBOs by considering them in the context of mergers and acquisitions generally. In China, with the further reform of state-owned enterprises, and the changing of government's economic function after China's entry to the WTO, it is certain that the state economic construction will be adjusted accordingly.

It is anticipated that an improvement of the legal regime will be more helpful and constructive to the development of management buy-outs, which could in turn be actively beneficial to China's efforts in economic reform.

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